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MEASURES AND INCENTIVES FOR ENHANCING THE COMPETITIVENESS OF SECTORS WITH EXPORT POTENTIAL IN DEVELOPING COUNTRIES: EVIDENCE AND LESSONS FROM EXPERIENCE

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SUMMARY AND CONCLUSIONS

Resources for development

(i) In their pursuit of greater participation in international trade, many developing countries still face the task of building internationally competitive production bases, including efficient commercial support services and modern infrastructure facilities. The production of new exportables and changes in the structure of production in line with shifts in a country's comparative advantage are unlikely to come about without adequate resources for investment, the acquisition and adaptation of new skills and new technologies and - with progressing development - R & D and innovation activities.

(ii) The importance of resource availability is reflected strikingly in the fact that satisfactory growth and diversification of exports has been recorded mainly by middle- and high-income developing countries. Experience points to the particular importance of the availability of foreign capital at the same time as a shift from import substitution to export promotion is taking place.

Role of government in building competitive supply capability

(iii) In the real world, market failures occur in product and factor markets and the working of the price system can fail to achieve an efficient allocation of resources. Moreover, a country's comparative advantage can be changed through learning and through government action.

(iv) Government policies need to correct for market failures and should aim to accelerate the process of accumulation of physical and human capital and thereby build up competitive strength which the private sector could not accomplish by itself, or at least not as rapidly. Without such intervention, a country's production structure runs the risk of remaining shallow, technologically backward and lacking in dynamism.

(v) Experience shows that functional and selective policy measures are needed to correct for market failures and build up comparative advantage. Efficient functional measures are almost a precondition for designing effective selective interventions geared to particular learning needs. Functional and selective measures must be completely transparent and permit an assessment of their benefits and costs to the economy.

Features of trade policy experience

(vi) The efficient conduct of trade policy is a crucial building block for export expansion. Evidence from a number of developing countries which recorded rapid export growth suggests that exchange rate devaluations (in real terms), export incentives, and the operation of export processing free zones and special economic zones have figured prominently in the trade policy measures used to promote exports. Furthermore, sectoral targeting has been an instrument for implementing both trade and industrial policies in support of export expansion and industrial development. The policy mix has varied among countries and over time. Trade liberalization has followed, rather than accompanied export growth, with the exception of the liberalization of imports of inputs for export production.

(vii) A number of these features may also be encountered in the trade policies of developing countries which have recorded comparatively less satisfactory export performances. Evidently, similar strategic approaches or policy instruments are used more effectively by some countries than others.

Exchange rate management

(viii) Avoidance of currency over-valuation is fundamental in ensuring international competitiveness of export supply capabilities. An important factor in the failure of devaluations to increase export supply has been the inability of Governments to ensure that the real exchange rate fell significantly then stayed down long enough to permit adjustment of supply. The translation of a nominal devaluation into a real depreciation which is sufficiently large and sustained has proved to be a difficult exercise in many developing countries. In some cases, Governments have been forced to delay or minimize exchange-rate adjustments for fear of social and political consequences.

(ix) Improvements in the trade balance following a devaluation have often been short-lived, while inflationary pressures increased, setting in motion an inflation-devaluation spiral and undermining the credibility of exchange rate devaluations as a useful policy instrument. Trade balances can also deteriorate in the wake of devaluations, at least in the short run, as export expansion grows with varying time lags, while the expected shrinkage of imports in response to higher prices may not occur. Exchange rate policies pursued for other objectives than the support of export expansion may be incompatible with intentions to promote the export sector.

(x) Low-income, commodity-dependent economies can encounter particular problems over the short- and medium-term in their exchange rate management. Thus, the immediate supply response of primary commodity exports to a devaluation depends crucially on the short-term elasticities of supply of individual commodities. Such elasticities can be low. As regards manufactured products, the supply response is likely to be limited as installed production capacity in low-income developing countries is normally small. In many of them it suffers from acute physical disrepair of plant and equipment.

(xi) A devaluation in support of export expansion can be self-defeating if a small number of countries supply the bulk of a commodity which has a relatively high long-run supply elasticity. A devaluation by one country can then lead to competitive devaluations by others, expanded world supply and depressed world prices.

(xii) The experience with exchange rate auctions and interbank markets in low-income developing countries as a means of instituting more market-determined exchange rate systems is still relatively recent and, so far, inconclusive. While flexibility is, in principle, desirable, an attempt to simulate free floats exacerbates volatility in expectations, contributes to instability and limits planning horizons. An emphasis on predictability would imply a preference for managed exchange rates. Auction systems in foreign-exchange scarce countries are highly donor-dependent and are likely to fail if they are initially underfunded.

Export incentives

(xiii) The provision of export incentives can offset or mitigate competitive disadvantages inherent in home market protection and in the developmental stage of manufacturing export sectors of developing economies. Experience shows that the design of export incentive schemes and their implementation is a complex undertaking. Four points require careful attention by policy-makers: the effectiveness and coherence of individual measures in promoting exports; the effective administration of these measures; their economic cost; and their compatability with GATT rules.

(xiv) Free access to imported production inputs at world market prices and the operation of export-financing facilities have proven to be important incentives for the promotion of manufactured exports. Financing facilities for exports on short-term payment conditions are crucial at earlier stages of development when shortcomings of the commercial banking system are still pronounced. The favourable impact of income tax concessions on export performance has not been evident to the same extent, particularly in the case of large established exporters and foreign-owned companies and in the presence of weak tax collection systems.

(xv) Export credit insurance schemes are technically complex undertakings; they have operated successfully only in a few developing countries. Most developing countries still lack sufficiently large and diversified export volumes, a solid base of established exporters and diversified export markets. Consequently, they do not have a reasonable spread of risks which would allow insurance operations to be conducted on a cost-recovery basis. Export credit insurance schemes estabished at too early a stage in the development process have often failed to earn a premium income that would cover operational costs. The requirement of acceptable security remains a major obstacle confronting exporters of non-traditional goods in negotiating export finance with commercial banks.

(xvi) Inefficiencies in the administration of export incentives have impaired their promotional impact in many developing countries. Complex, protracted administrative procedures have detracted considerably from the incentive value of import duty concessions for imported production inputs. Moreover, the outlays on export incentives and revenue foregone owing to such incentives add to the domestic resource cost of exporting. Evidence suggests that Governments were often more concerned with maximizing exports as such, rather than with efficiency in promoting exports.

(xvii) Export incentives which are meant to offset competitive disadvantages inherent in the developmental stage of the economies of developing countries are fully consistent with their competitive and developmental needs and are, in consequence, in conformity with GATT rules. Income tax and import duty concession are, in any case, permitted under GATT provisions and so are export credit insurance facilities which operate on a cost-recovery basis.

Sectoral targeting

(xviii) Sectoral development programmes can serve to enhance the competitiveness of selected industries by correcting for market failures and through active support aimed at accelerating the pace of the sector-specific

capability-acquisition process. Scarcity of resources poses for Governments the problem of selecting a relatively small set of industries which "deserve" promotion. Sectoral programmes need to target activities that have a good chance of reaching international competitiveness within a reasonable period. In this way, Governments guide capability-building efforts towards areas of emerging comparative advantage.

(xix) Government support measures in the context of sectoral development programmes must be based on a realistic assessment of the technological, input, scale and institutional constraints facing the future development of the promoted sectors, including the time needed to mount the necessary efforts. Temporary protection from import competition can be an important policy tool to correct for market failures which result from the existence of a steep learning curve, for example. Preferential investment finance and low-cost working capital as well as assistance with the absorption of new technologies, with selecting foreign capital equipment and technology and with training in specific skills (which may, in turn, be geared to new technologies) are further support measures which have been used to remedy constraints in promoted industries.

(xx) There are three main reasons why sectoral development programmes have in many cases failed to build internationally competitive supply capabilities. First, failures have occurred where developing countries have attempted to "make a leap" into an industry which was far beyond their existing capabilities in terms of financial, human and technological resources. Secondly, government-supported sectoral programmes carry the risk that enterprises might reduce their own investments in capability acquisition and slacken their efforts to improve competitive strength. Home-market protection, in particular, allows firms to content themselves with domestic operations and to neglect export expansion. Thirdly, Governments have often lacked the institutional capability correctly to identify the constraints on the promoted industries, to tailor support measures to sector-specific needs or to implement sectoral programmes which required detailed information and highly specific interventions.

(xxi) The experience of some developing countries that have successfully pursued sectoral strategies suggests a number of safeguards which can be employed to ensure that government support in the context of sectoral development programmes is geared systematically towards the achievement of international competitiveness: assurance of competition among domestic firms in the home market; encouragement of enterprises to enter export markets as soon as the learning process permits (e.g. linking attractive financial incentives like preferential investment finance and low-cost working capital to the fulfilment of export targets; elimination of the anti-export bias of infant industry protection through export incentives); continual monitoring of the costs and benefits of support measures; and pre-announced timetables for the implementation of government-supported sectoral development programmes.

(xxii) At earlier stages of development, sectoral development programmes should be relatively simple in design and aimed at easing basic financial, skill and technological constraints on the promoted activities. Technical cooperation with international organizations can play an important role in assisting developing countries with the choice of sectors for promotion and the design, implementation and monitoring of sectoral programmes.

Export processing free zones (EPZs)

(xxiii) A number of EPZs in developing countries have faced serious economic and operational problems. Administrative hurdles, inadequate infrastructure and insufficient transportation links with major export markets are among the factors which have discouraged investors. In addition, the development cost of EPZ sites has tended to be high. Thus, the zones have not in all cases made a net contribution to the income of the host economies.

(xxiv) Developing countries should clearly define the function they wish EPZs to perform in their industrialization and export policies, taking account of the developmental impact made in the past by EPZs. The EPZ device may be considered primarily as an additional source of foreign exchange earnings and employment. Labour-intensive processes and component specialization in EPZs within vertically integrated transnational industries constitute a relatively easy avenue for developing countries with infant industry export sectors to expand into manufactured exports and realize immediate foreign exchange earnings.

(xxv) The transformation of activities in EPZs from essentially assembly and other low-skill operations into more complex and sophisticated manufacturing operations with greater linkages with the domestic economies is subject to a number of constraints. The investment strategies of foreign corporations in EPZs are essentially based upon the utilization of low-cost labour. As and when internationally competitive production inputs become available locally, the administrative ease of the import duty exemption associated with EPZ operations becomes less important and other considerations, such as proximity to local supplies, can become more a determinant in the locational decision of investors.

(xxvi) Developing countries should monitor continuously the economic profitability of the EPZs for their economies. The cost of the construction of the EPZ estate and government subsidies and incentives crucially influence the profitability of EPZs for the host economies. It is important, therefore, to avoid excessive expenditure on EPZ estate development and costly promotion policies. The operational efficiency of EPZs and administrative ease of import duty exemption, with normally zero opportunity cost for the host economy, should be the major incentive by which any EPZ can attract investors.

Approach towards import liberalization

(xxvii) Empirical work on the sequencing of macroeconomic stabilization and liberalization of imports has shown that macroeconomic stabilization should be the first step. Experiments with shock treatment involving the simultaneous implementation of major stabilization policies, structural reforms and import liberalization have, by and large, proved unsuccessful.

(xxviii) Most of the developing countries which undertook to liberalize imports have proceeded selectively and gradually. Experience with relatively rapid and simultaneous liberalization of all production sectors, with uniform reductions in protection across sectors, has been highly unsatisfactory. A uniform approach cannot do justice to the wide structural and capability differences existing among developing countries as well as among production sectors and their support systems. Industrial activities differ in their

skill requirements, scale, technological, organizational and linkage characteristics and so imply different learning periods and costs. Rapid across-the-board liberalization can lead to an irreversible loss of capital and the disappearance of accumulated skills; it may even hold back the development of new, more complex activities.

(xxix) In determining the level of protection for infant manufacturing activities and the time period over which such protection can be withdrawn, policy-makers need to take into account the different learning periods of production sectors and the differences in their competitive strength. Hence, the design and implementation of liberalization would need to be more sector-specific.

(xxx) With sector-specific liberalization, the removal of protection from particular sectors would proceed in line with gradual improvements in their competitiveness. The lowering of protection would be an additional stimulus to greater efficiency, while the pace at which protection is reduced would be adjusted so as to allow sufficient time for adjustment efforts of entrepreneurs and government support measures to lead to international competitiveness. Sector-specific liberalization would have to be closely coordinated with support measures under sectoral development programmes aimed at building efficient supply capabilities.

(xxxi) While sector-specific liberalization and sectoral development programmes lead to variations in the level of protection between different industrial activities, the structure of incentives should not create a bias within industries in favour of production for domestic markets. Rather, equal incentives should be provided for selling at home and abroad. It is therefore crucially important that export incentives offset the bias in favour of domestic operations implicit in home market protection.

(xxxii) Gradual import liberalization in step with improvements in the competitive strength of supply capabilities is an effective means to keep entrepreneurs on track with their efforts to achieve international competitiveness. The gradual release of protection need not wait until after sustained export growth has been recorded.

(xxxiii) Import liberalization is, on the other hand, far from being a sufficient prerequisite for export growth. Weak supply capacity, poor infrastructure and organizational capabilities limit what can be achieved with the simple manipulation of price incentives through import liberalization.

Transparent mechanisms

(xxxiv) The developing countries should assess on a continuous basis the benefits and costs of government support measures such as export incentives and support in the context of sectoral development programmes or through the operation of EPZs. Independent national mechanisms could be set up for undertaking critical and objective assessments. The Cartagena Commitment adopted at UNCTAD VIII has recommended the establishment of such mechanisms to enhance the transparency of trade-related policy-making.

INTRODUCTION

1. Sustained export growth of the developing countries depends crucially on two major parameters: an open international trading system offering unhindered access to export markets and the existence of internationally competitive supply capabilities in the developing countries. This report focuses on national measures and incentives of developing economies aimed at enhancing the competitiveness of their exports.

2. In their pursuit of increased participation in international trade, many developing countries still face the task of building internationally competitive production bases with efficient agricultural, manufacturing and services sectors. The degree of development may of course vary between countries and sectors. Impediments to export growth imposed by constraints on the supply side can be daunting: lack of investment capital and goods; shortages of skilled labour; insufficient technological capabilities and inadequate physical infrastructure. In addition, an insufficiently developed service sector can affect the competitive strength of developing countries, given the importance of many services (such as banking, telecommunications, transportation, marketing and distribution) for manufacturing and agricultural sectors. 1/ Moreover, lack of political stability and continuity can be a stumbling-block as it does not allow for the longer term planning horizon needed by entrepreneurs and policy-makers in fostering international competitiveness.

3. The competitive strength of products from developing countries is, to a large extent, influenced by price which, in turn, depends on a number of factors. Among them figure the levels of and trends in relative labour cost, exchange rates and productivity. Various non-price factors gain in significance as determinants of increasing market share as a country's comparative advantage progresses in the direction of more skill- and technology-intensive industries. Competitive strength is then increasingly determined by factors such as product quality, design and image, innovativeness, management and marketing efficiency, short response times to new market opportunities and reliable after-sales service.

4. It is beyond the scope of this report to deal with the entire range of national measures and incentives used by Governments to promote exports; consequently, the approach adopted here is selective. Chapter 1 highlights briefly the importance of resource availability in building competitive export supply capabilities and the role of government intervention in the development of national productive bases. Chapter 2 examines the trade-policy experiences of a few selected developing countries. Chapters 3 to 9 proceed to analyse in greater detail the experience of developing countries with exchange-rate management, export incentives, sectoral targeting, export processing zones, and import liberalization. The last chapter attempts to highlight some lessons on the use of these measures, of special interest to developing countries.

Chapter I

THE BUILDING OF COMPETITIVE EXPORT SUPPLY CAPABILITIES

A. Resources for development

5. The production of new exportables and changes in the structure of production in line with shifts in a country's comparative advantage both require investment, creation of new skills, acquisition and adaptation of new technologies and, with progressing development, R & D and innovation. None of this is likely to come about without adequate resources for development. The importance of resource availability is reflected to a marked degree in the fact that satisfactory growth and diversification of exports have been recorded mainly in those developing countries with relatively high domestic savings and investment rates. Indeed, some 15 such economies account for about 90 per cent of manufactured exports from all developing countries.

6. The need for investment funds, human skills and technology grows when a country sets out to launch a strategy of active promotion of export expansion and diversification. If export promotion is accompanied by liberalization of the country's trade regime, the additional exposure of import-substituting activities to world market competition will further increase adjustment pressures on the productive base and, hence, heighten the need for resources to restructure industrial and other economic sectors. A paucity of the human resources required to implement reforms can also be a serious impediment not only to realizing the potential benefits of reforms but even to their implementation. In several instances, there have been considerable gaps between the commitments of Governments to reform and the actual reforms undertaken.

7. Experience points to the particular importance of having foreign capital available during a shift from import substitution to export promotion. The mobilization of external resources can be a crucial determinant for the success of such a policy reorientation. The Republic of Korea and Taiwan Province of China may serve as illustrative examples. Ghana is another case in point. 'The country's reforms undertaken in the 1980s were generously supported by the international community (IMF, World Bank and bilateral donors).' Ghana, as the model of a successful and willing reformer, was singled out in Africa for massive funding. With financial support from abroad, the country was able to undertake, inter alia, infrastructural rehabilitation projects (in the field of transport, power, communication and water supply) aimed at restoring an effective base of support services indispensable for export growth.

8. Few other low-income developing countries are likely to receive a comparable level of funding. Neither the IMF nor the World Bank, upon which Ghana's reform programme relied so heavily, could be expected to spread their degree of involvement in Ghana across the African continent, let alone among all low-income developing economies, given the current level of resources of these financial institutions.

B. Rationale of government intervention in building export supply capabilities

9. The challenge for developing countries is the implementation of policies which support, rather than hamper export expansion. The objective should be to reduce the incidence of uneconomic or counter-productive government interventions and controls and to move to a different, and much reduced, set of policy measures geared to the pursuit of creating diversified internationally competitive supply capabilities. The scope of such policy measures continues to be the topic of extensive debate.

1. Correction of market failures

10. In the real world, markets do not always function perfectly, nor do efficient market structures emerge by themselves. Rather, market failures occur in product and factor markets. The working of the price system can fail to achieve efficient allocation of resources. Factor market failures are likely in areas such as: physical infrastructure; labour markets; human capital; science and technology; capital and financial markets; technology imports; and various industry-related support institutions. Product market failures may be of three types: anti-competitive behaviour by large firms in oligopolistic markets; lack of information and high transactions costs; and the effects of international competition on new entrants which bear the brunt of significant "learning" costs (infant industry failures). Market failures can arise, in particular, from the existence of externalities, e.g. circumstances where a private-enterprise system will not invest or tends to under-invest in certain activities which generate significant national wealth but reward private firms poorly. Hence, government interventions are necessary to correct for market failures. Without such interventions, a country's production structure risks remaining shallow, technologically backward and lacking in dynamism.

2. Building comparative advantage

11. Economic development is a continuous process of capability acquisition which imparts a dynamic dimension to the comparative cost advantage of national economies. As more capital and skilled human resources are accumulated, a country's comparative advantage moves from unskilled labour-intensive activities to capital-intensive ones and to R & D intensive pursuits. Investment, human-resource development and technological progress are the major driving forces behind the dynamic evolution of competitive strength.

12. While some factor endowments which determine a country's comparative advantage are "natural" and exogenous (e.g. natural resources), many other determinants are based on elements which are at least partially controllable (e.g. human-resource development, technological innovation). The comparative advantage can, in consequence, be changed through learning and through government action. Thus, Governments can shape their countries' comparative advantage in order to help their goods and services enter world markets. Furthermore, Governments may be able to design policies which will accelerate the process of accumulation of physical and human capital and thereby build up

competitive strength which the private sector could not accomplish as rapidly by itself. This is essentially the message of the new trade theory which goes beyond the consideration of failures inherent in certain markets. 2/

c. The use of functional and selective government interventions

13. Both functional and selective interventions can be used to correct market failures and build comparative advantage. Functional interventions are designed to promote economic development without favouring one activity over another. They are essentially economy-wide measures such as the provision of general skills (say, primary or secondary education) or general incentives in support of exports or broad-based technological efforts. Conversely, selective interventions are geared to the particular learning needs of a specific activity and its interlinkages and, thus will favour specific production sectors. Protection during difficult learning stages (infant industry protection) and support to individual industries to meet their specific training and technology needs are major forms of selective interventions. 3/ Efficient functional policy measures are a precondition for the conduct of effective selective interventions which are the instruments for "fine-tuning" the process of developing internationally competitive supply capabilities. Both functional and selective measures need to be completely transparent and allow for assessment of their benefits and costs to the economy.

14. Selective interventions are often considered to involve a relatively greater risk of costly government failures. Prima facie, it would appear that selective intervention to correct a well-defined weakness in skill or technology in a particular industrial sector is not more complex or demanding than a functional intervention in factor markets to raise skill levels or technological capabilities economy-wide. Moreover, a failure in functional intervention such as insufficient attention to scientific knowledge in secondary education can be more costly than ill-designed interventions in comparatively limited areas of economic activity.

Chapter II

OVERVIEW OF THE TRADE POLICY EXPERIENCE OF SELECTED DEVELOPING COUNTRIES

15. A broad range of national economic policies influence export performance on the supply side. Important elements of a policy framework aimed at ensuring international competitiveness are macroeconomic stability, high rates of domestic savings, education policies that create and maintain a solid base of human skills, and technology policies to promote technological change and technology infrastructure. Evidently, the efficient conduct of trade policy is another crucial building-block for export expansion. A brief overview of the trade policy experience of selected developing countries is presented below.

A. Description of country experiences 4/

16. Starting in the early 1960s, the Republic of Korea pursued forceful export policies and a systematic targeting of selected industrial sectors for promotion. 5/ Thus, the Government maintained a competitive exchange rate and provided strong export incentives, including the operation of export processing free zones. At the same time, the Government pursued import substitution in a range of new, increasingly complex industries. Output and exports responded quickly to the policy incentives provided. The export expansion which followed was exceptionally dynamic. A moderate liberalization of quantitative restrictions on imports took place in 1967, but tariffs remained high and direct import controls extensive until as late as 1978, when a gradual pre-announced programme of import liberalization was initiated.

17. A deliberate policy shift from labour-intensive to heavy industry began in the early 1970s. The level of protection was selectively increased and fiscal and financial incentives were provided to encourage the domestic production of steel, chemicals, shipbuilding and machinery. The further development of these industries encountered problems towards the end of the 1970s, mainly due to over-hasty execution and exogenous shocks (second oil price rise, mounting interest rates, serious recession in major export markets) and some of the investments had to be restructured or trimmed. The restructured facilities achieved international competitiveness as the "learning" process, sheltered from import competition, matured. By the second half of the 1980s, over half of the country's manufactured exports originated in heavy industry. 6/

18. For almost two decades, starting in the late 1960s, Brazil succeeded in combining high protection with rapid export growth and a progressive diversification in the composition of its manufacturing exports. Transnational corporations played an important role in export expansion. The approach of the Government's trade policy in the promotion of exports involved essentially a combination of export incentives and gradual monetary devaluations. Moreover, weak domestic demand in the 1980s induced, to some extent, producers to enter export markets in order to maintain production levels. The interruption of the country's export boom in the mid-1980s was a consequence of major problems created by the macroeconomic imbalances in the country, rather than of deficiencies in trade policies.

19. A programme of import liberalization was adopted only in 1990. However, the extended practice of local content requirements has been maintained, while the so-called BEFIEX system, which gave exporters access to restricted imports, was dismantled. In addition, real exchange rate appreciation has accompanied the trade reforms. This configuration implies a severe bias against exports which does not augur well for the durability of the trade reform programme. 7/

20. In Malaysia, there was a real appreciation of the exchange rate at the beginning of the 1980s, due largely to heavy inflows of capital. The country's export competitiveness suffered accordingly and it was not until the real exchange rate began to depreciate after 1984 that Malaysia's exports began to grow rapidly. 8/ Although Malaysia has low non-tariff barriers and relatively low tariffs, the structure of protection has not been neutral. Thus, effective tariff protection rose, particularly in the machine and capital goods sector, as a result of a heavy industrialization programme launched in the early 1980s.

21. The country's export success has been based primarily on a variety of export incentive measures (which offset the anti-export bias inherent in protection) and a policy of attracting export-oriented foreign direct investment, particularly into export processing free zones. Malaysia, together with other countries of South-East Asia, has enjoyed significant external economies resulting from the relocation of industrial operations from Japan and, to a lesser extent, from the United States and the more advanced developing countries of the region. The relocation of export production in Malaysia was brought about by a loss of competitiveness on the part of the relocating countries in labour-intensive activities and to some extent by the imposition of non-tariff restrictions in major markets against imports from the more advanced developing economies in the region. Foreign-owned companies accounted for more than one-third of the paid-up capital of companies in production at the end of 1988. In general, industries with foreign participation exported at least half of their output.

22. Costa Rica with a small economy, was able to resume moderate but stable export growth after the economic collapse of the early 1980s. In the second half of that decade, the pace of export expansion accelerated considerably. Export growth has been based on a rapid diversification of exports into non-traditional agricultural and manufacturing goods. Policy measures which helped significantly with export expansion have been a sharp real devaluation brought about through a crawling peg system and intensive use of export incentives. Thus, exporters may receive direct income tax cuts and rebates of 15 to 20 per cent on gross foreign sales, as well as the usual duty exemptions for imported inputs. Preferential access to the United States market under the Caribbean Basin Initiative also contributed to export growth. Import liberalization was not introduced until 1986 and was only moderate and implemented gradually. Relatively high effective protection rates have remained the rule in the early 1990s. 9/

23. Colombia has had a long tradition of protection and strong intervention in trade and foreign exchange management, although it has also mixed these policies with export promotion and gradual devaluation since the 1960s. There was a gradual liberalization of imports from the early 1970s up to 1982 but, in the face of a balance-of-payments crisis, this policy was sharply reversed

in the period 1983 to 1985. The Government responded to the crisis with a substantial real devaluation, increases in tariffs and quantitative restrictions along with the introduction of export subsidies. After 1985, import liberalization was resumed, but it was only in August 1991 that the gradual approach towards liberalization was abandoned and replaced by more rapid reductions of trade barriers.

24. The Colombian economy has experienced relatively fast economic growth, particularly from 1974 to 1981. Moreover, despite the temporary return to a more protectionist stance and the collapse of prices of the country's major export commodity (e.g. coffee) in the 1980s, exports grew in real terms twice as fast in 1981-1991 as in 1974-1981 when gradual import liberalization had been the prevailing policy approach. Furthermore, exports diversified more rapidly in the 1980s, particularly as a result of large mining investments and the provision of incentives to promote non-traditional agricultural and manufactured export products.

25. China is one of the most notable examples of a country with rapid export growth in the 1980s, based on a programme of measures adopted in the late 1970s. These policies included a significant devaluation of the currency; the decentralization of the management of foreign trade; an export contract system whereby foreign trade corporations entered into contracts for the implementation of the plan (in terms of foreign-exchange earnings, production costs for exports and total size of the trade deficit); the active use of Hong Kong's commercial agents and facilities; and the establishment of several Special Economic Zones (which did not make an important contribution to export expansion until the second half of the decade). Although foreign trade continued to be highly regulated and protected, real exports tripled in the decade following these reforms. 10/

26. Turkey was able to transform many of its import-substituting sectors into export industries in the 1980s. 11/ Although a boom in manufactured exports was experienced in the period 1970 to 1973, it was cut short by the real appreciation of the currency in the mid-1970s. A combination of real devaluation and high export subsidies, including special incentives for foreign trading companies, subsequently led to a dynamic expansion of manufactured exports, starting in 1980. Although some export incentives have been reduced since the mid-1980s, they have been compensated for by increases in other incentives and remained high in 1990. Import liberalization only commenced when export expansion had gained ground. Quantitative restrictions on imports were reduced in 1984 and virtually eliminated in 1988. Tariffs were cut substantially in 1989 and 1990. These reforms coincided with a slowdown in the growth of manufacturing exports, on account of a concomitant anti-inflationary programme, which brought about a real appreciation of the exchange rate starting in 1989. In consequence, the relative price incentive for exports was eroded.

B. Major features of trade policy experience

27. The above evidence from selected developing countries which recorded fast export growth suggests that exchange rate devaluations (in real terms), the provision of export incentives and the operation of export processing free zones and special economic zones have figured prominently among the trade policy measures implemented to promote exports. Furthermore, sectoral

targeting has been used as an instrument of both trade and industrial policies in support of export expansion and industrial development. The policy mix has varied among countries and over time. Trade liberalization has followed, rather than accompanied export growth, with the exception of the liberalization of imports of inputs for export production.

28. The impact of these policy measures is not neccesarily the same for price and non-price competitiveness. Likewise their importance may vary for different economic sectors. Thus, exchange rate management, import liberalization and export incentives are mainly directed at enhancing price competitiveness, while sectoral targeting and export processing free zones aim to improve both price and non-price factors. Furthermore, exchange rate management impacts on all economic sectors (unless multiple exchange rate systems are in force), whereas programmes of import liberalization in developing countries have focused on manufacturing industries. Export incentives and sectoral targeting have, in practice, essentially been used for the promotion of manufacturing sectors, and export processing free zones have been instruments to foster manufacturing and, to some extent, service activities.

29. These features - exchange rate devaluations, export incentives, targeting of industries for promotion, export processing zones, and the minor role of trade liberalization - can also be encountered in the trade policies of other developing countries, among which many which have recorded a comparatively less satisfactory export performance. Evidently, similar strategic approaches or policy instruments are used effectively by some countries and less effectively by others. Details of design and implementation apparently matter a lot, and there are pitfalls which policy-makers must detect and avoid. Our discussion will first turn to the use of devaluations in the promotion of exports.

Chapter III

EXCHANGE RATE MANAGEMENT BY DEVELOPING COUNTRIES IN SUPPORT OF EXPORT EXPANSION

A. Main features of experience

30. The avoidance of currency over-valuation is fundamental in ensuring the international competitiveness of supply capabilities. Devaluations of the real exchange rate have played a pivotal role in strategies to increase exports and have formed part of external adjustment efforts in many developing countries. 12/ Following a devaluation, increases in exports will, in the short term, come essentially from the utilization of unused capacity; in the longer term, they come from augmented capacity and the transfer of productive resources from import substituting and non-traded goods sectors to export activities. Not only the building of new capacity but also rigidities encountered in the transfer of resources across sectors and infrastructural bottlenecks can stretch the adjustment period considerably.

31. An important factor in the failure of many devaluations to increase export supply has been the inability of many Governments to ensure that the real exchange rate fell significantly and remained at a depreciated level for a period long enough to permit adjustment of supply. 13/ Empirical evidence points to a positive relationship between the level of a country's development and the ability to translate nominal devaluation into real devaluation. 14/ Furthermore, if imported inputs are relatively significant in production for export, gains in price competitiveness due to devaluations may be reduced as a result of higher import cost. The creation of competitive domestic supply capabilities which can replace imports can take many years to accomplish.

32. A problem which often emerged was that improvements in the trade balance following a devaluation tended to be short-lived, while inflationary pressures increased. 15/ The relatively short duration of the favourable effect of devaluations on the trade balance follows in part from the inflationary impact which weakens (and often offsets) the initial real devaluation, erodes the price advantage of tradeables and restores the original (pre-devaluation) relative prices for traded and non-traded goods. Evidence from a number of developing countries for the 1960s and 1970s suggests that the price advantage for tradeables was largely eroded within a period of up to three years. 16/ Similarly, evidence from the 1980s indicates that devaluations undertaken in developing countries involved a significant inflationary impact in most of these economies. 17/

33. Where a devaluation increased inflation without sufficiently improving the balance of trade, another devaluation was eventually induced, setting in motion an inflation-devaluation spiral and undermining the credibility of exchange rate devaluation as a policy instrument. 18/ Most discussions of devaluations, therefore, stress the need to combine the switching policy of devaluation with expenditure-dampening measures to restrain internal demand and preserve the change in relative prices resulting from the devaluation. 19/

34. Furthermore, trade balances can deteriorate following a devaluation, at least in the short run. The explanation is that export expansion will occur with varying time lags, while the expected shrinkage of imports in response to higher prices may not eventuate, particularly when less essential imports had been largely restricted beforehand and domestic substitution possibilities were limited. Rather the import volume may increase immediately, as more exports may depend on a higher inflow of imported raw materials as well as capital equipment and spare parts to rehabilitate previously neglected plant and equipment.

35. Exchange rate policies pursued for objectives other than the support of export expansion may be incompatible with intentions to promote the export sector. In Chile, the trade regime was drastically liberalized in the 1970s, but the exchange rate policy at that time was aimed at slowing down inflation. As a result, the real exchange rate became over-valued, with negative effects on export growth. Exports began to grow significantly only after the real exchange rate was allowed to depreciate. 20/

B. Evidence from sub-Saharan Africa

36. An issue that has attracted considerable attention is the responsiveness of the supply side to exchange rate changes in low-income developing countries which export essentially primary commodities. Using pooled cross-section and time series econometric analysis for 20 manufactures exporters, 11 fuel exporters and 18 primary commodity exporters over the period 1965 to 1985, it has been found that real devaluation was effective in improving the trade balance in the first group of countries but not in the latter two. 21/ This section will review in greater detail the experiences of some sub-Saharan African countries in the 1980s (e.g. Ghana, Kenya, Malawi, Tanzania, and Zambia).

37. The reforms of exchange rate policy in Ghana had progressed further than in any other African country. In a number of stages between April 1983 and January 1986, the Ghanaian cedi was devalued from 2.75 cedis per United States dollar to 90 cedis per dollar. By mid-1986, with the cedi still over-valued, the Government decided to move from a pegged exchange rate with discrete devaluations to a floating rate mechanism. The instrument chosen for this was the introduction of a weekly foreign exchange auction system. In February 1988, the exchange rate reform moved into a third phase with the introduction of foreign exchange bureaux. The reform was concluded in April 1990 with the establishment of a wholesale auction for foreign exchange in the context of an inter-bank market. 22/ These changes implied a shift towards a more flexible, market-determined exchange rate system. It allowed for a faster and more regular flow of foreign exchange into all sectors of the economy.

38. In 1985, Zambia also introduced a foreign exchange auction system allowing market forces to have a greater influence in the determination of the exchange rate. However, considerable constraints, hampering a free determination of the exchange rate, remained. 23/ Moreover, the Government discarded the reform 19 months later, in May 1987, when it terminated its agreements with the IMF due to differences over policy conditionality, and returned to the administrative allocation of scarce foreign exchange.

39. Exchange rate reforms of other sub-Saharan developing countries have been much more cautious. Governments were often forced to delay or minimize exchange rate devaluation for fear of social and political consequences. Kenya, Malawi and Tanzania carried out several devaluations in the 1980s, but stopped short of adopting (or were unwilling to implement) flexible and market-oriented exchange rate policies. Thus, no effort was made to change the foreign exchange allocation systems. In many respects, therefore, the thrust of exchange rate policies remained unchanged. 24/

40. To the extent that exchange rate devaluations (and other changes in exchange rate management) formed part of broader structural adjustment programmes, it is difficult to assess the relative impact on export performance of exchange rate policy reforms, on the one hand, and of other policy changes (import liberalization, introduction of export incentives, etc.), on the other hand. This qualification needs to be kept in mind, when a correlation is established between exchange rate changes and export growth. The table presents the relevant data for the five sub-Saharan sample countries.

41. In the case of Ghana, the strong real devaluations and the move to a more market-determined exchange rate system were matched by a strong improvement in export performance. Exports which had recorded strong declines in 1980-1983, recovered and the trade balance moved from deficit into surplus, (in nominal values) in 1985. In the case of Zambia which recorded a gradual real depreciation of its exchange rate in 1980-1987, the decline in exports slowed down, but growth rates remained negative until 1985. After a short period of export expansion, the exchange rate appreciated 25/ then exports declined again sharply in 1988, one year after the IMF-supported reform programme had been abandoned.

42. In Kenya and Malawi real exchange rate depreciations over 1980-1988 were relatively small (in particular in Malawi) and a tendency towards appreciation emerged towards the end of the decade. Neither in Kenya nor in Malawi can changes in real export growth be consistently related to changes which occurred in real exchange rates. Rather, the picture is erratic and inconclusive. In Tanzania, progressive devaluations were undertaken by the Government in the early 1980s, but these devaluations were apparently not large enough to induce a depreciation in the real exchange rate. Instead, between 1980 and 1985, the real exchange rate appreciated by over 50 per cent. Nevertheless, export growth was by and large relatively strong in real terms despite the appreciation.

43. All the sample countries with one exception (Tanzania) showed a steady increase in manufactured exports (in value terms) in 1980-1988 irrespective of exchange rate movements. In Tanzania the value of manufactured exports declined in the first half of the 1980s when the exchange rate appreciated.

Table

Selected sub-Saharan developing countries: total export growth a/ manufactured exports and exchange rate movements b/ (1980-1988)

	1980	1981	1983	1985	1987	1988
GHANA						
Total export growth	-13	-8	-45	6	29	7
Manufactured exports in million US$	25	32	20	12	26	33
Real Exchange Rate Index	100	198	163	40	24	23
KENYA						
Total export growth	5	-4	-2	7	3	5
Manufactured exports in million US$	210	149	173	178	200	201
Real Exchange Rate Index	100	84	74	73	80	77
MALAWI						
Total export growth	33	-17	3	-5	8	-5
Manufactured exports in million US$	31	31	15	20	37	40
Real Exchange Rate Index	100	93	85	76	84	94
TANZANIA						
Total export growth	24	29	-8	30	13	0
Manufactured exports in million US$	82	71	46	50	55	60
Real Exchange Rate Index	100	113	134	152	71	58
ZAMBIA						
Total export growth	-3	-12	-9	-2	13	-12
Manufactured exports in million US$	12	9	9	22	20	20
Real Exchange Rate Index b/	100	93	85	55	39	68

Source: UNCTAD Secretariat, based on World Bank database.

a/ Real export growth in per cent.

b/ Real exchange rate index 1980 = 100.

44. The above evidence from the few sample countries is admittedly sketchy and does not permit final conclusions. On the one hand, the experience of countries which pursued a cautious approach towards exchange rate management (e.g. Kenya, Malawi, Tanzania) indicates that relatively small real devaluations are apparently not sufficient to make a tangible impact on export growth in low-income commodity exporting countries. On the other hand, the case of Ghana cannot be taken as proof that a bold approach towards exchange rate reform, involving a strong real devaluation and a shift towards more market-oriented exchange rate systems, will generally contribute to export expansion of low-income commodity-dependent economies.

45. Ghana presents a special case in several respects. First, the devaluations helped to generate a strong recovery of the country's traditional exports essentially because of the production and marketing characteristics of cocoa, the dominant export crop. Short-run supply elasticities proved to be relatively high for this crop. 26/ In contrast, the impact of devaluation in Zambia was much less effective because of the very different nature of copper production and markets. Short-run supply elasticities have been much lower for copper than for cocoa and other tree crops. Secondly, the auction system implemented in Ghana benefited from a sizeable increase in external assistance so that the initial demand for foreign exchange could be satisfied. In the case of Zambia, a lack of sufficient external funding contributed, in no small part, to the failure of the auction system that was abandoned in 1987. Thirdly, the price of Ghana's main export product, e.g. cocoa, rose sharply in the first four years after the introduction of the reform programme in 1983, allowing the Government to provide an additional export incentive through repeated massive increases in producer prices over and above price increases made possible through devaluations.

46. Apparently a strong depreciation in real terms must be complemented by other factors to induce a tangible export supply response in low-income commodity-dependent economies. The short-run supply elasticities of the countries' major commodity exports evidently play a major role. 27/ Such elasticity can be low. As regards manufactured exports, low-income developing countries have little production capacity in place which can respond quickly to the changed price signal of a devaluation, and the creation of such capacity requires investment, skill formation and time. Hence, supply response will tend to be slight in a short to medium perspective. The achievement of a competitive exchange rate through devaluation and its maintenance in the long run are, however, indispensable to support export expansion via a reallocation of resources to exportables in a longer-term perspective.

Chapter IV

EXPERIENCE WITH FISCAL EXPORT INCENTIVES

A. Income tax concessions

47. Many developing countries have granted tax incentives in the form of income tax concessions. Various types of income tax concessions have been applied to benefit exporters: exemptions from income tax (e.g. Brazil, El Salvador, Guatemala, Mexico, Panama, Uruguay); income tax rebates (e.g. Bangladesh, Ghana, Pakistan, Singapore); deductions in the calculation of income tax (e.g. Argentina, Brazil, India, Malaysia, Peru, Philippines, Singapore, Sri Lanka, Thailand); and tax credit certificates (e.g. Malaysia, Costa Rica, Colombia, Peru, Philippines). Some countries have used various forms of income tax concessions, permitting them to adjust the incentive benefit to particular characteristics of the export business.

48. The benefit from these concessions depends very much on the profitability of the export business. The lower the profits as a proportion of value added, the less an income tax concession is worth in terms of the equivalent export subsidy rate. 28/ Consequently, income tax concessions result in greater financial gains for established companies with a large export turnover than for newcomers to the export sector whose profits are likely to be slight during the initial years of operation.

49. The effectiveness of these concessions in stimulating additional exports may none the less be greater in the case of new exporters than for companies with well-established export volumes. Income tax concessions can be an important factor in the decision of producers to enter export markets despite small initial profits, while firms with profitable export turnovers may see in these concessions a simple fringe benefit, rather than an incentive to intensify their export efforts.

50. The extent of fiscal evasion in the exporter's country will affect the attractiveness of exemptions from or reductions in income tax. In countries where the tax collection systems are not sufficiently effective, the value of income tax concessions as an export incentive measure can be significantly reduced.

51. Additional considerations apply when foreign export-oriented firms and, more specifically, transnational corporations which have invested in the developing country are the beneficiaries of income tax concessions. Available evidence suggests that tax holidays - complete exemption from taxes on corporate profits - have not as a rule greatly influenced the investment decisions of foreign firms. 29/ The attractiveness of income tax rebates has also proven to be relatively limited as transnational corporations can use the transfer pricing mechanism to build up profits where it suits them, e.g. by overcharging for materials and components supplied to the subsidiary in the developing country. Similarly, foreign firms have been able to manipulate their profit and loss statements through excessive depreciation. 30/

52. However, this is not to say that the complete elimination of profits in the host developing country is necessarily in the interest of the foreign firm's global strategy of maximizing profits or minimizing tax payments. A number of developed market-economy countries offer tax credit arrangements under which tax paid by the foreign subsidiary in the developing country on its repatriated earnings is credited against the tax liability of the parent corporation to its home Government. In these cases, tax credits can be computed in such a manner that the parent firm's total tax payment is minimized when a certain tax is paid to the host developing country. 31/

53. Tax concessions which are granted to foreign-owned companies lead to a transfer of income from the developing country to the foreign firm's home country if the latter offers a tax credit arrangement. This is because the tax credit provision does not apply to the extent that the developing country grants a tax concession and, hence, loses revenue. The home country records, in consequence, a gain in income. Developing countries would be well-advised to assess carefully the potential promotional impact of income tax concessions on export performance before granting such concessions.

B. Concessions with regard to import duties on imported production inputs

54. Import duty concessions designed for the stimulation of manufactured exports provide for the refund of duties paid on imported materials and components which are used in the manufacture of goods intended for export (the so-called import duty drawback facility). Alternatively, exporters may be allowed to import duty-free the materials and components used in producing goods for export. Such a temporary importation facility can be an arrangement for manufacture-in-bond or simply a permission to import duty-free on the execution of an export bond. 32/

55. Import duty corcessions have been a prominent feature of export incentive schemes in many developing countries (e.g. Brazil, Chile, Côte d'Ivoire, Indonesia, Republic of Korea, Malaysia, Mexico, Nigeria, Peru, Philippines, Senegal, Thailand, Venezuela). These concessions have proven to be an important incentive for the promotion of manufactured exports. Import duties on imported materials and components used in production for export inflate the cost of the exporter and adversely affect the exporter's competitiveness in international markets. The drawback of, or exemption from, customs duties eliminates or mitigates the adverse impact of higher input cost.

56. In practice, a number of shortcomings have impaired the effectiveness of import duty drawbacks and exemptions as an export incentive device. First, the administration of these incentive measures tends to be cumbersome and time-consuming. Secondly, drawback arrangements still require the exporter to pre-finance the higher input cost until receiving the refund. This financing cost remains even when the exporter is exempted from paying the import duties, because such an exemption normally depends on the provision of a bank guarantee, which is released only after the exports have been transferred. Thirdly, owing to practical difficulties in determining the import content of the export product, drawback arrangements seldom provide for a complete refund of duties paid.

57. Evidence suggests that complex and protracted administrative procedures have been the most serious obstacle in many developing countries. Problems have varied depending on the specific form in which the concession is granted. Some of the problems are difficult to eliminate through procedural streamlining. They mainly concern the adequacy of drawback rates. The test of a satisfactory system of drawback is its ability to provide full refund of the duty incidence. The reimbursement should equal the duties paid, so as to achieve the objective of making the export item competitive in export markets. Exporters have generally complained that drawback rates are in many cases inadequate, that is, less than the duty paid.

58. A number of reasons account for inadequate rates. Duties may have been raised substantially whereas the necessary amendment of the rates of drawback is only undertaken with considerable delay. Likewise, prices of production inputs may have increased sharply, without being followed up expeditiously by changes of the rebate rates. Thirdly, standardized rates may, in individual cases, prove to be inadequate, as they are based on statistical averages. To some extent, a remedial measure would be to calculate standardized rates liberally in favour of the exporter. 33/

Chapter V

EXPERIENCE WITH FINANCIAL EXPORT INCENTIVES 34/

A. Preferential export finance

59. The availability of finance for exports, in adequate measure and at reasonable cost, constitutes an important competitive element for exporters of manufactured products. Exporters need financing through all phases of the production and sale cycle. At the pre-shipment stage, the exporter requires credit from banks for the purchase, manufacture, processing or packaging of goods, and at the post-shipment stage, he must bridge the liquidity gap between shipment of the goods and receipt of payment.

60. The capacity of the exporter to offer the buyer deferred payment terms is of particular importance. As competition in the world market with regard to exports of manufactures becomes more and more severe, buyers are in a position to demand and obtain from their suppliers favourable payment terms. Stringent financial policies in many buyer markets, characterized by credit squeezes, also induce buyers to press for easier terms of payment. Furthermore, the efforts of manufacturers and exporters in a number of developing countries to produce and export capital goods of greater sophistication will bring them into a field of international trade where medium-term and long-term credit terms have become a normal feature.

1. The problems encountered

61. Exporters of manufactured goods in developing countries still find it difficult to obtain sufficient competitive low-cost finance from the banking sector. In many of these countries, the commercial banking business had been for a long time concentrated in the hands of foreign banks. They saw their primary role as financing exports of raw materials from the developing country and imports of manufactured goods into it. Bank offices were mainly established in the principal towns and commercial centres. Domestic banking developed later, and remained for a long time of secondary importance. The banking attitude was oriented towards short-term profitability. Finance was requested for traditional business by established clients, and consisted mainly of short-term loans. Medium-term and long-term credit was not considered by the banks as coming properly within their sphere of operations.

62. The shortcomings of the banking system became obvious when manufacturing industries emerged in the developing countries. The commercial banks which tended to follow conservative lending policies were reluctant to grant finance to new exporting manufacturing industries, as such financing often implies higher risk with lower profitability. To the extent that finance is forthcoming, banks require the exporter to provide collateral to meet strict rules of liquidity and eligibility. The collateral demanded tends to be high relative to the amount of finance provided, in particular in the case of new exporters who are most in need of finance, but have only limited assets to offer as collateral.

63. In consequence, manufacturers and exporters in developing countries face serious competitive disadvantages vis-à-vis the export sector in developed market-economy countries, with regard to obtaining finance in adequate measure and at reasonable cost. First, in developed market-economy countries, the production and export of manufactured goods constitute an established sector of the economy which is able to offer the commercial banks an attractively large volume of business. Secondly, their industries are serviced by commercial banks and an array of specialized financing institutions such as discount houses, factoring houses and export banks that are adequate for, and responsive to, their needs and, in addition, have international connections through a network of subsidiaries and correspondent banks abroad. Thirdly, the general level of money market interest rates in developed market-economy countries is usually much lower than in developing countries. To some extent, major industrialized countries also support the provision of low-cost, medium-term and long-term export credit out of public resources. Fourthly, the export sector in the developed market-economy countries normally has no difficulty in furnishing adequate bank collateral. In addition, the export trade in manufactures of those countries, being well-established, is less risky than the non-traditional export trade of many developing countries, whose exporters are only just starting to establish new business relations and venture into new markets.

64. A greater number of developing countries have established government-sponsored schemes to assist their exporters of manufactures with overcoming the competitive disadvantages faced in international trade with regard to availability of export finance. These facilities have attempted to offer practical solutions to three main problems: (a) assurance of easily available financing; (b) provision of competitive low-cost financing; (c) provision of adequate bank collateral. The normal method of achieving these objectives has been the implementation of government-sponsored export financing and export-credit insurance schemes.

2. The financing facilities

65. The bulk of exports of manufactured and semi-manufactured goods from developing countries is sold on short-term payment conditions with maturities of up to six months or, in exceptional cases, one year as a maximum, Likewise, the production cycles involved tend to be short. Thus, the working capital requirements at both the pre-shipment and post-shipment stages can normally be met by short-term credits within a maturity of three to six months.

66. The main method applied to increase the availability and reduce the cost of short-term finance for exporters of manufactures and semi-manufactures has been the provision of (a) refinancing facilities for commercial banks with central banks or (b) government-sponsored export financing funds. The commercial banks are offered refinancing at concessional rates, provided they do not charge the manufacturer-exporter more than a certain maximum interest rate, which is fixed by the competent governmental authorities at a rate slightly higher than the preferential refinancing rate. In this way, the manufacturer-exporter obtains finance at moderate cost enabling him to meet foreign competition. Among the developing countries which have operated

facilities along these lines are: Argentina, Brazil, Chile, Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Indonesia, Jamaica, Malaysia, Mexico, Pakistan, Philippines, Republic of Korea, Singapore and Thailand.

67. Export credit on favourable terms constitutes an important element of competition in the case of exports of capital goods which are sold on medium-term and long-term credit of up to 10 years. Many developed market-economy countries have implemented government-sponsored export credit financing systems which provide medium-term and long-term export finance. Some major developed market-economy countries operate government-backed financing institutions especially set up for the financing of their capital goods exports. 35/ Export credit can be furnished at favourable interest rates within the framework of minimum rates laid down in the "Arrangement on Guidelines for Officially Supported Export Credits", agreed by States members of OECD.

68. In view of the highly competitive export-credit financing schemes operated in developed market-economy countries, an increasing number of developing countries have also felt the need to provide for preferential financing of their exports of capital goods sold on medium-term and long-term credit. Inevitably, export-credit facilities will have to be provided in those developing countries wishing to export the types of goods which are currently being sold on deferred payment terms by exporters in the developed countries with the assistance of preferential export credit schemes. If developing countries wish to break into world markets with new export products, they will at least have to match the terms demanded of, and already being met by, exporters in the developed countries.

69. So far, few developing countries have introduced financing facilities in support of export sales on longer-term maturities. Some of these, among them Argentina, Chile, Colombia and Mexico, have extended the short-term refinancing facilities of their central banks to cover export sales on longer-term credit. In Brazil, longer-term financing of exports has been provided by the Foreign Trade Department (CACEX) of the Bank of Brazil, using the resources of a public export financing fund. The Republic of Korea and India have set up special institutions to provide finance and banking services for longer-term exports. 36/

70. Preferential arrangements for the provision of export finance to the export sector have, by and large, operated satisfactorily from a purely technical point of view. The schemes have been able to mobilize more and cheaper export finance. However, they do not normally assume the financial risks involved in export financing operations. 37/ Central banks or other public institutions providing preferential refinancing continue to have full recourse to the commercial banks for the repayment of their loans in case of need. Consequently, the commercial bank, in turn, calls upon the exporter to put up the collateral which it deems appropriate. Thus, the requirement of highly acceptable security remains a major obstacle confronting exporters of non-traditional goods in negotiating export finance with commercial banks.

B. Government-sponsored export credit insurance

71. In order to mitigate the exporter's collateral problem, the following developing countries and territories operate governmental or government-backed export credit insurance schemes: Argentina, Barbados, Colombia, Cyprus, Ghana, Hong Kong, India, Jamaica, Malaysia, Mauritius, Mexico, Pakistan, Peru, Republic of Korea, Senegal, Singapore, Sri Lanka, Trinidad and Tobago, and Zimbabwe.

72. By and large, these schemes offer two basic types of insurance facilities that supplement each other. First, export credit insurance coverage extended to the exporter protects him from the risk of non-payment by the foreign buyer; secondly, guarantees issued to commercial banks secure pre-shipment and post-shipment export finance which the banks furnish to exporters; these guarantees cover the banks against losses that may arise as a result of failure by the exporter to repay the loan. 38/

73. While an export credit insurance scheme is to be considered an integral part of a government programme of export expansion, it is nevertheless intended to operate on a self-supporting basis as early as possible. The facility aims at earning premium income that will allow it to pay its way from year to year. In developing countries, achievement of a cost-recovery operation at an early stage has proved to be a major hurdle. The main obstacle to such self-sufficiency has been that the insurable export volume, in particular of manufactured goods, is still comparatively small, and hence, yields little premium income. However, the provision of such facilities to exporters in the developing countries at premiums far higher (so as to be self-sufficient) than those charged to exporters in the developed countries is obviously not practicable either, as it would adversely affect international competitiveness.

74. The problem of achieving a cost-recovering operation is not easy to solve, as is borne out by experience. Re-insurance possibilities are limited by the small insurance volumes, often involving a below-average spread of risks, which are not sufficiently attractive for large re-insurance companies. Moreover, re-insurance for political risks is, by and large, not available in the private insurance market. 39/ An alternative avenue might be the establishment of government-backed regional export credit insurance institutions which could offer both direct insurance to exporters in developing countries without national schemes and re-insurance to existing national institutions. 40/

Chapter VI

ADMINISTRATIVE SHORTCOMINGS AND COST OF EXPORT INCENTIVES

75. Inefficiencies in the administration of export incentives have impaired the promotional impact of such incentives in many developing countries. Some shortcomings have already been mentioned. Others of a more general nature are briefly examined in this section.

A. General administrative deficiencies 41/

1. Involvement of several authorities

76. In the case of a number of export incentives, several different authorities are involved in the implementation of one and the same incentive measure. An illustrative example is the administration of import duty drawback schemes for the refund of duties on imported inputs for export production. The verification of the exporter's statements made in his application for fixing the drawback rate, the fixation and notification of the rate, and, after shipment of the goods, the processing and payment of the drawback claim, are under many schemes entrusted to three different authorities. Similar situations may be encountered in the case of other export incentives. The necessity of having to deal with several authorities has proved to be time-consuming and often exasperating for exporters.

2. Over-cautious safeguards

77. In the administration of export incentives, precautionary measures are taken with a view to preventing benefits being granted where no rightful claim exists and to forestall abusive practices. Safeguards and controls are applied in various forms. A safeguard frequently encountered is to require the exporter, before the incentive benefit is granted, to furnish a bank guarantee for the purpose of securing fiscal responsibility and other public interest concerns.

78. It stands to reason that safeguards and controls cannot be abolished completely if export incentives schemes are to work to the common economic benefit. However, safeguards should not make the administration unwieldy, or burden the exporter unnecessarily with additional cost. It seems that prevailing procedures have been designed in many cases to catch "would-be defaulters", rather than cater to the requirements of the normal run of exporting manufacturers who conform to rules and regulations laid down in respect of export incentives measures.

3. Slow processing of applications

79. Speed and efficiency of the administration of incentive measures depend not only on the structure of the administration and the extent of safeguards and controls applied, but also on the administrative style in which applications for incentive benefits are handled and the administrative expertise with which they are processed. Experience shows that the administration is in many cases too slow and benefits reach the exporters only with considerable delays.

80. Available evidence suggests that inefficiency in the processing of applications tends to work to the particular disadvantage of small exporters, especially those who are new to the export business. They have difficulties in coping with the amount of paperwork and in dealing with the various officials concerned, as they have neither the time nor the staff to follow up their applications continually. These difficulties are less pressing in the case of large exporting entrepreneurs which can apply "economies-of-scale" even in this regard, as they possess the financial means to employ a number of staff exclusively for handling export incentive claims.

4. Inconsistency of administrative decisions

81. Administrative bodies have often been inconsistent in their decisions on applications for export incentive benefits, making it difficult for the exporter to determine in advance the incentive benefits which he might be granted. The reason for inconsistencies can be a certain degree of arbitrariness on the part of administering officials. Inconsistencies may also result when officials are not fully familiar with all entitlement criteria, which are frequently laid down in a number of laws and regulations. In other cases, discretionary powers given to the officials can be the cause of incompatibilities in decision-making, as officials may differ in the interpretation and application of laws and regulations concerned.

82. The resulting uncertainty can adversely affect export performance. The exporter should know, before he takes on an export order, if he will be entitled to export incentive benefits. As these benefits are important factors in the exporter's costing, advance knowledge is an essential prerequisite for a firm, competitive price quotation. Similarly, the point in time when a certain benefit will be obtained is important in terms of the exporter's cash-flow position. The ability to assess in advance if and when the exporter can obtain a preferential licence for the import of certain machinery can also be relevant, for instance in cases where large export orders with a good chance of renewed orders depend on the expeditious expansion of the exporter's production capacity.

B. The cost of export incentives

83. The fact that export incentives have helped with export expansion (albeit to an extent not easily determined) says, of course, little about the cost of these measures to the national economies. The developing countries which introduced export incentives did not necessarily encourage the development of those export industries which could have earned foreign exchange at relatively low domestic resource cost. 42/ Governments were frequently more concerned with maximizing exports as such - disregarding their countries' comparative advantage - rather than with efficiency in promoting exports. Thus, there is evidence that predominantly high domestic resource cost of earning foreign exchange was, for instance, incurred in Brazil, Colombia, Egypt, India, the Philippines as well as in Spain and Turkey. 43/ The outlays on export incentives and revenue foregone owing to such incentives added to the domestic

resource cost of exporting, in particular where incentive schemes displayed a bias towards fixing the subsidy inversely to the competitive strength of the exportable commodity, involving the danger of causing a net loss to the economy. 44/ Nevertheless, it has been argued that misallocation of resources resulting in high domestic resources cost tends to be less serious under export-oriented policies than under import substitution because export incentives require visible budgetary expenditure. 45/

Chapter VII

TARGETING INDUSTRIAL SECTORS FOR PROMOTION: THE EXPERIENCE OF THE REPUBLIC OF KOREA

84. The promotion of selected industries has been a feature of trade and industrial policies in a great number of developing countries. In many cases, the priorities for industrial promotion were set by development plans, normally designed for five-year periods. The target industries have often been relatively capital-intensive production branches. Brazil, China, India, Indonesia, Malaysia, Mexico, the Republic of Korea, and Singapore are among the developing countries which have pursued sectoral development programmes. Similarly, some developed market-economy countries have implemented sectoral strategies for the promotion of selected high-technology industries. 46/ Sectoral development programmes have often failed to build internationally competitive supply capabilities.

85. The Republic of Korea is one of the countries which has been successful in shaping industrial development through sectoral policies. The Government has pursued a highly effective interventionist strategy to foster new lines of internationally competitive industry and develop their export potential. This chapter takes a closer look at the country's experience with the promotion of selected industries.

A. Main support measures in sectoral targeting

86. The particular targets of government intervention in the Republic of Korea have been infant industries along with those industrial sectors which were perceived to have lost competitiveness, entailing the need for rationalization and upgrading. 47/ A number of major support measures were applied to develop the selected industries.

87. Thus the promoted production sectors were temporarily sheltered from import competition. Effective rates of protection were often high and non-uniform across industries. The array of import controls included, inter alia, tariffs, quantitative import restrictions, import licensing, the administrative allocation of foreign exchange and advance deposits. 48/

88. Preferential access to long-term credit for the financing of investment at interest rates well below market rates has been another important instrument of promotion. Similarly, preferential access to low-cost working capital was made available to promoted industries. 49/ Furthermore, firms were given liberal access to foreign technologies, primarily in the form of new equipment and licensing. Technology policies also provided for government assistance given directly to firms through public or semi-public technology research institutes. The support provided included assistance in engineering and design.

89. Supplier industries were often promoted together with their user industries. Thus, assistance by technology institutes was, for instance, directed at increasing the production and raising the quality of locally produced inputs for the manufacture of machine tools. 50/ Moreover, local content regulations were applied whenever the acquisition of technological capability and subsequent adaptive innovation required extensive interaction

between users and suppliers. 51/ Where government incentives failed to induce the creation of desired industries, public enterprises were established. Thus, the first producers of fertilizers, petrochemicals and refined petroleum products in the Republic of Korea started out as public ventures. 52/

B. Determinants of efficiency in government intervention 53/

90. The sectoral development programmes succeeded in building international competitiveness of the promoted activities. Several factors have been crucial in ensuring the efficiency of sectoral targeting by the Government.

1. Focus on capability acquisition and selectivity of intervention

91. All interventions have been closely geared to the particular capital and learning needs of the promoted activity and its interlinkages. In addition to protection from imports, interventions have aimed at specific improvements in factor and product markets considered necessary for the development of the promoted sector. Thus, the creation of many skills as well as technological and other institutions, and the support of technology imports were specifically intended to accelerate the learning process in industries selected for promotion.

92. The set of promoted infant industries was generally small at any point in time. Public intervention was apparently aimed at economizing on scarce investment resources and entrepreneurial and technical personnel. Besides sector-specific action, government measures have been firm-specific, singling out those enterprises that were seen to stand the best chance of succeeding. 54/

2. Choice of sectors in line with emerging comparative advantage

93. The risk of costly mistakes by the Government in choosing production sectors for promotion ("picking the winners") was significantly reduced as industrial activities were promoted in line with the likely nature of evolving changes in the country's comparative advantage. Interventions were aimed at building competitive supply capabilities in a sequential order, proceeding from simpler lines of activity to the development of progressively more sophisticated capabilities. Thus, new activities built incrementally on existing human and technological capabilities. The Government could, to some extent, base its strategy on the earlier experience of developed market-economy countries (in particular, Japan). It also enjoyed the advantage that there was a pool of available technologies which could be imported, imitated or improved upon without having to take on the risks and the costs borne by the "pioneers".

3. Export promotion and early exposure to competition

94. The potential anti-export bias of home-market protection for infant industries was offset by strong export incentive measures. While the structure of protection implied a strong industry bias, there was no trade bias in favour of domestic markets despite protection. Rather, incentive schemes slightly favoured exports over domestic sales. 55/

95. Furthermore, the promoted infant industries were exposed to competition at an early stage, but the approach taken was not import liberalization. The danger that imports from highly efficient foreign firms might have pushed fledgling domestic firms out of the market was judiciously avoided. Instead, exposure to competition was achieved by encouraging competition in the domestic market among infant producers and by urging firms to start exporting at an early stage. Export targets were established for each promoted industry and failure to meet targets carried considerable sanctions. Moreover, the formation of trading companies was supported as an instrument for undertaking activities needed to strengthen and expand marketing capabilities.

4. Monitoring implementation

96. The Government has continuously monitored the impact of interventions with the objective of assuring that international competitiveness of the promoted infant sectors would be achieved within a medium-run time frame. The Government kept a close watch over the export performance of assisted industries and the magnitude of incentives provided. Market information obtained in the process of policy implementation - such as information pertaining to the relationship of domestic to international prices or to the costs and benefits of an industry's operation - was kept under surveillance and translated into policy changes, if revision was considered necessary in order to maintain momentum towards the achievement of international competitiveness.

97. When the targeted industries had reached sufficient competitive strength, and needed less intervention, support measures were withdrawn from these sectors; new activities were then chosen for promotion in line with the country's evolving comparative advantage. In this way, the set of promoted industries changed over time, while the composition of industries which had gained competitiveness reflected earlier interventions in factor and product markets.

5. Neutral stance of Government

98. Extensive consultations by the Government with the private sector have been an important element in the process of policy formulation and implementation. In this way, a great deal of uncertainty associated with selective intervention has been progressively resolved during implementation. While the Government provided support, it succeeded, in preventing costly rent-seeking by the private sector. The Government displayed the capacity to keep special interest groups at bay, or at least to channel their capacities in directions that advanced the public interest. The industrialization strategy promoted, in consequence, the welfare of the country as a whole, rather than benefiting certain pressure groups attempting to change the distribution of incomes in their favour.

Chapter VIII

EXPORT PROCESSING FREE ZONES

99. A large number of developing countries have set up export processing free zones (EPZs) as focal points for the promotion of manufactured exports and the attraction of foreign export-oriented investment. Moreover, EPZs are increasingly being used to attract service activities, in particular off-shore banking operations. Production in EPZs is in most cases exclusively oriented towards international markets.

100. The first EPZ in a developing country was established at Kandla in India in the mid-1960s. Today, there are more than 200 such zones in developing economies. The establishment of EPZs was at first concentrated in South and South-East Asia (e.g. India, Indonesia, Malaysia, Philippines, Republic of Korea, Sri Lanka) and Latin America (e.g. Barbados, Brazil, Chile, Colombia, Dominican Republic, El Salvador, Haiti, Jamaica, Mexico). Few EPZs existed in Africa in the 1970s (e.g. Mauritius, Senegal, Tunisia). However, since the 1980s, EPZs are increasingly being established on the African continent, in particular in sub-Saharan Africa (e.g. Zaire, Togo, Madagascar, Cameroon, Kenya). Others are currently under study (Benin, Comoros, Malawi, Nigeria, Rwanda, Zanzibar, Zimbabwe). China has set up Special Economic Zones, covering very large areas. At the end of the 1980s, the Asian EPZs accounted for 65 per cent of all EPZ exports, the zones in Latin America for 32 per cent and those in Africa for 3 per cent.

101. A number of EPZs run into serious economic and operational problems. Administrative hurdles, inadequate infrastructure and insufficient transportation links with major export markets are among the factors which have discouraged investors. In addition, the development cost of EPZ sites has tended to be high. Thus, the zones have not in all cases made a net contribution to the income of the host economies. Some zones have not yet become fully operational although they have been in existence for a number of years.

102. EPZs in developing countries have by and large attracted non-complex production units which are often vertically integrated into transnational enterprises. The foreign firms have moved labour-intensive stages of their production processes to EPZs, mainly in response to labour-cost differentials between developed and developing countries. Major sectors of production in EPZs are electronics, clothing, footwear, leather products, electrical products, optical goods, plastics, toys, sporting goods, car parts and minor transport equipment.

103. The major attraction of successful EPZs has proven to be their operational efficiency. They enable time-consuming procedures on importation into the zones and exportation from the zones to be kept to a minimum: imports of raw materials, intermediate products, equipment and machinery required for production are not subject to payment of customs duty; 56/ import restrictions are not applicable and import licences are not required for importation into the zones. Manufacturers in EPZs can place their import orders overseas in accordance with their production needs and are assured of timely availability of production inputs, enabling them to meet export commitments without delays.

104. Reliable physical and commercial support services and the far-reaching centralization of administrative functions under EPZ authorities are further elements of operational efficiency attractive to investors. As firms often prefer the least contact with government authorities and officials, the EPZ authorities also serve as the interface between zone enterprises and local authorities, negotiating, where necessary, matters of concern with the local bureaucracy on behalf of the firms established in the zones. This simplifies procedures for foreign investors to set up and operate their business in an unfamiliar environment.

105. The developing countries have pursued a number of specific, target-oriented objectives with the operation of EPZs. The following government objectives have been associated with these zones: (a) generating foreign exchange earnings; (b) creating employment; (c) attracting foreign capital and technology; (d) acquiring and upgrading labour and management skills; and (e) creating linkages between EPZ industries and the domestic economy. If the economic impact of EPZs is measured against this rather ambitious set of objectives, the contribution of the zones to the further economic development of the host countries has in most cases not been fully satisfactory. 57/

A. Foreign exchange earnings, employment creation and foreign investment

106. The foreign exchange earnings generated for the host economies by EPZ exports are the amount earned on domestic value added. It is estimated that between 20 and 40 per cent of the gross value of exports goes to the host country. Owing to the import-intensity of production in EPZs, wages account for the major proportion of domestic value added. The balance is accounted for mainly by charges paid for local public and private services, including energy, lease of land and the rent of factory buildings to EPZ enterprises. Income from the local supply of tradeable production inputs to companies in EPZs is in many cases insignificant.

107. Employment in all EPZs located in developing countries is currently estimated to be slightly more than 1 million persons, less than 3 per cent of the total officially registered workforce in manufacturing industries in developing countries. The contribution of foreign investment in EPZs to the capital stock of the host economies has been comparatively unimportant, as EPZ plants are normally simple production units carrying out labour-intensive operations which do not require expensive machinery or equipment. By and large, the capital investments made by foreign enterprises in EPZ production sites in the 1970s and 1980s did not normally exceed $1 million in any one case and were often well below $500,000.

B. Technology transfer

108. Technically sophisticated production processes are not normally found in EPZs. A production strategy which locates only the labour-intensive part of the production process in EPZs is not likely to result in substantial technology transfer. Production stages which require advanced technology have tended to stay in the industrialized countries. Thus, in semi-conductor manufacturing, the two high-technology processes, mask-making and wafer fabrication, are undertaken in the developed countries. Likewise, in the

textile-related industries, capital and technology-intensive textile production, especially that of man-made fibres, has not been redeployed in EPZs. Cases where higher level technologies such as colour television and printed circuit technology have been introduced into EPZs are still exceptional. Moreover, an alleged lack of patent protection for foreign technology has contributed to the reluctance of foreign investors to inform local technicians, in particular, where host developing countries are not members of the "International Convention for the Protection of Industrial Properties".

109. Furthermore, the dissemination to local firms of technology from foreign firms established in EPZs is very much dependent on technical cooperation agreements between enterprises inside and outside the zones. Technical cooperation agreements leading to an increased flow of technology into the host country have remained exceptions. Generally, the enclave nature of these zones has hampered the development of such relationships. In addition, there is little or no research and development undertaken in EPZs.

C. Labour and management skills

110. The EPZ production sites offer employment predominatly for low-skilled manpower performing simple manual operations which can be learned in a comparatively short time. Many of the managerial functions such as marketing and production planning are carried out by the parent companies overseas, rather than by the subsidiaries in the EPZs. As a rule, foreign companies fill the key posts of general manager and treasurer in subsidiaries in EPZs with their own expatriate personnel. For middle level positions, firms are willing to recruit and train local management and engineering personnel which is less costly than expatriate staff. Many firms, in particular transnational corporations from Japan, with subsidiaries in EPZs have sent local technicians to developed countries for training. Training given in areas such as quality control and marketing has familiarized local personnel with world market specifications. Nevertheless, local technicians in EPZs in developing countries have complained about a certain reluctance of foreign supervisors to allow them to gain a comprehensive understanding of the production process.

D. Backward linkages

111. EPZs have, by and large, maintained their enclave character and have not established any substantive linkages with the industrial sector of the host economies. The reason is largely the bias implicit in the EPZ device in favour of import-intensive operations. Because of the vertical integration of many EPZ operations into the transnational production process, these operations depend heavily on intra-firm imports of supplies. Foreign companies are concerned with maintaining the linkages within their own international production network rather than with establishing links with the host economies. To the extent that enterprises situated in EPZs are free to purchase their inputs wherever they wish, they tend to choose locally produced inputs only in cases where these exist, meet the quality requirements and can be supplied at world market prices.

E. Mobility of EPZ enterprises

112. Foreign companies operating in EPZs are potentially very mobile. Cheap, productive labour is readily available at many places in developing countries. The preference for relatively small plants in EPZs, the low investment cost per workplace, the use of relatively inexpensive and simple equipment, the lack of backward linkages and the availability of standard factory buildings in nearly all EPZs enable companies to relocate production from one developing country to another comparatively quickly. The foot-loose character of industries in EPZs has, nevertheless, sometimes been over-estimated. Cases where firms have left EPZs "overnight" are exceptional. Conversely, decisions to invest in EPZs are essentially influenced by the prevailing wage levels, which decisively affect international competitiveness. A substantial rise in labour costs at an EPZ production site is in consequence likely to lead to a decrease in potential investment in the zone.

Chapter IX

IMPORT LIBERALIZATION

A. Macroeconomic stabilization and import liberalization 58/

113. In recent years, policy recommendations have increasingly come out in favour of a shock treatment which involves the simultaneous implementation of major stabilization policies, structural reform and import liberalization, thus discarding the traditional sequence whereby macroeconomic stabilization was regarded as the first step. However, experience with the "big bang" approach has not been very encouraging. The earliest example (mild by later standards) was the policy package introduced by Chile in the mid-1970s. Owing to the shock treatment, the country's economic growth remained moderate and unstable for a long period. Bolivia adopted a large-scale stabilization-cum-liberalization programme in 1985. Hyperinflation was stopped, but economic growth remained below 3 per cent per annum over the period 1986-1991. More recent experiences in Latin America have highlighted some of the more dangerous effects of this approach. In particular, in those countries where a "sudden shock" has been used to stop hyperinflation, a common characteristic has been massive over-valuation of the domestic currencies. Expectations of devaluation then continue to fuel inflation, while persistent macroeconomic instability stifles structural adjustment and, more specifically, the investment response of entrepreneurs to import liberalization.

114. The tendency to mix structural adjustment policies with anti-inflationary programmes is much more general than the "big bang" episodes would suggest. Major trade reforms were adopted as part of essentially anti-inflationary packages in Mexico in 1987, in Turkey in 1989-1990 and in Colombia in 1991. In these cases also, real appreciation was a by-product of the programmes, simultaneously reducing the incentives for import substitution and exports. In all these countries, rapid export growth slowed down after the stabilization-cum-trade reform programme was adopted.

B. Experience with rapid "wholesale" import liberalization

115. Most of the developing countries which began to liberalize their import regimes in the 1980s have followed a gradual and selective approach in reducing home market protection. Few developing countries have implemented relatively rapid import liberalization simultaneously in all industrial sectors with uniform reductions in protection across sectors. The experience with fast "wholesale" liberalization has been disappointing. No country has so far achieved strong growth of output or exports as the result of such a policy. Chile and Mexico are the most prominent examples. 59/

116. Over the period 1974 to 1979, Chile carried out a sweeping liberalization programme, abolishing all non-tariff barriers and reducing tariffs, which were high and varied significantly among sectors, to a uniform rate of 10 per cent. The programme was part of a broader set of policy changes designed to leave all microeconomic decision-making to the private sector. The liberalization experiment proved to be costly for the Chilean economy. Many potentially viable firms in the manufacturing sector were forced to close down under the impact of unselective, fast liberalization (and also because of exchange rate

over-valuation). Between 1973 and 1989, the Chilean economy grew at less than 1 per cent annually in per capita terms. Exports recovered only in the early 1980s, especially for copper and natural resource-based products. The strong export expansion which followed may essentially be attributed to the correction of the severe currency over-valuation in 1982, the introduction of some export incentives and large new investments in mining, agriculture, fisheries and forestry. The uniform tariff level was, in fact, raised from 10 per cent to a peak of 35 per cent in response to the economic crisis of the early 1980s, though it was subsequently again brought down, to 11 per cent in 1991. The surge in investment seems to have been a response to the perception that the Government's policies would remain favourable to investment in natural resource industries, rather than a reaction to trade liberalization which applied primarily to the manufacturing sector, in any case.

117. In the manufacturing sector, the response of entrepreneurs to import liberalization was, in part, to become importers of some of the goods they formerly produced, using their established distribution networks in the domestic market, rather than to upgrade their production and enter export markets. Unselective and rapid liberalization had not left sufficient time for many enterprises which might otherwise have survived to carry out the structural adjustments required to improve their competitive strength. The result was a loss of production capacity and manufacturing know-how. 60/

118. The development of Mexico's manufactured exports was limited for a long time, despite the establishment of export processing free zones; it even experienced a major setback with the sharp rise in oil revenues and the greatly increased foreign indebtedness in the late 1970s and early 1980s. However, with an active exchange rate policy after 1982, Mexico experienced a boom in manufactured exports, involving a large-scale transformation of import substituting sectors into export industries. Exports included, in no small part, those from affiliates of United States companies to their home market. While these countries had originally set up business in Mexico to serve the domestic market, the re-orientation into exports was essentially brought about by the depression which had emerged in the domestic market and the steep depreciation of the peso.

119. Mid-1985, well after exports had begun to rise strongly, the Government launched a major import liberalization programme which was essentially accomplished some three years later. The Government eliminated most non-tariff barriers, abolished the system of customs valuation which served as an important and variable surcharge to tariffs, and reduced tariffs to an average of 12 per cent. However, the Government continued to use quantitative restrictions on imports to shelter some of its more successful export industries, particularly automobile manufacturing which will not be fully liberalized until 1994. The policy of broad-based and rapid liberalization exerted no tangible beneficial impact on the country's export performance. Rather, the growth of manufactured exports slowed down and exports became concentrated in fewer sectors, mainly as the result of a significant

appreciation of the domestic currency. This appreciation emerged with the implementation of a stabilization programme which was adopted in December 1987 together with an acceleration of import liberalization. 61/

120. In 1991, policies of unselective and fast import liberalization were launched by the Governments of Argentina and Colombia. It is still too early to assess whether or not, and to what extent, these policies will contribute to improvements in international competitiveness and export performances.

Chapter X

SOME LESSONS FROM EXPERIENCE

A. Exchange rate management

121. A competitive exchange rate belongs at the centre of industrial and trade policies and structural adjustment programmes. Experience indicates that initial devaluations would need to be relatively pronounced to make their impact on export expansion. The problem for Governments is to ensure that the real exchange rate falls significantly and remains at its depreciated level for long enough to permit adjustment of supply. The translation of a nominal devaluation into a real depreciation which is sufficiently large and sustained has proved to be a difficult exercise in many developing countries. Failures have been frequent in this regard.

122. Low-income, commodity-dependent economies apparently encounter special problems over the short and medium-term which they must consider in their exchange rate management. The immediate supply response of primary commodity exports to a devaluation depends crucially on the short-term supply elasticities of individual commodities. Such elasticities can be low. As regards manufactured products, the supply response is likely to be limited, as installed production capacity in low-income developing countries is normally small and suffers in many of them from acute physical disrepair of plant and equipment. Moreover, short-run supply can be foreign-exchange constrained if industries are highly dependent on imported production inputs.

123. If world market demand for a major commodity slackens, a devaluation would be no policy prescription for export expansion. Such devaluation (to restore levels of real relative prices) would only adjust local prices upwards in the face of falling world prices. Furthermore, a devaluation in support of export expansion can be self-defeating if a small number of countries supply the bulk of a commodity which has a relatively high long-run elasticity. A devaluation by one country will only lead to competitive devaluations by others, expanded world supply and depressed world prices. 62/

124. The experience with exchange rate auctions and interbank markets in low-income developing countries as a means of instituting more market-determined exchange rate systems is still relatively recent and is so far inconclusive. While flexibility is, in principle, desirable, attempts to simulate free floats exacerbate volatility in expectations, contribute to instability and limit planning horizons. A number of African countries which instituted floating rates switched back to a more controlled regime. A more cautious approach is apparently indicated. An emphasis on predictability would imply a preference for managed exchange rates. Moreover, auction systems in foreign-exchange-scarce countries are highly donor-dependent and are likely to fail if they are initially under-funded.

B. The use of export incentives

125. The provision of various export incentives can offset or mitigate the competitive disadvantages inherent in home market protection and in the developmental stage of manufacturing export sectors of developing economies.

In most countries, export incentives have been made available on a non-selective basis in support of all manufactured exports including agro-based manufactured products. Experience shows that the design of export incentive schemes and their implementation are complex undertakings. Four points require the careful attention of policy-makers: the effectiveness and coherence of individual measures in promoting exports; the effective administration of these measures; their economic cost; and their compatability with GATT rules.

1. Effectiveness of incentives

126. The potential impact of export incentives on export performance differs between particular measures (the impact of one and the same incentive may not be the same in the case of different beneficiaries). Free access to imported production inputs at world market prices and the operation of export financing facilities have proved to be important incentives for the promotion of manufactured exports. Financing facilities for exports on short-term payment conditions are crucial at earlier stages of development when shortcomings of the commercial banking system are still pronounced. The favourable impact of income tax concessions on export performance has not been evident to the same extent, in particular in the case of large established exporters and foreign-owned companies and in the presence of weak tax collection systems. Export-credit insurance schemes are technically complex undertakings and have operated successfully only in a few developing countries. Most developing economies still lack sufficiently large and diversified export volumes, a solid base of established exporters and diversified export markets and do not, therefore, have a reasonable spread of risks required to conduct insurance operations on a cost-recovery basis. Export credit insurance schemes which were established at too early a stage in the development process have failed to earn a premium income covering their operational cost.

2. Administration of incentives

127. The administration of export incentive measures, irrespective of their nature and specific objectives, should conform to a number of basic rules of efficient management. The failure to administer export incentives efficiently has frequently reduced their impact on export expansion.

128. Exporters should be required to deal with only one authority, irrespective of whether or not one or several official bodies are involved in processing the exporter's application for particular export incentive benefits. Furthermore, Governments may examine the possibilities for streamlining or eliminating unwieldy or costly safeguards which delay decisions on applications. The administration may rely to a greater extent on sanctions applied post facto in cases where it has been proved that the exporter was given the incentive benefit without fulfilling the requirements.

129. The manner in which applications are processed should be expeditious and unbureaucratic. Moreover, the authorities who administer export incentive measures have to be consistent in their decisions on applications for a particular export benefit. The exporter should be able to assess in advance with a reasonable degree of certainty whether or not he will be granted a specific incentive benefit with regard to a specific export transaction.

3. Cost of incentives

130. In providing export incentives, developing countries should not only look at the increase in exports that might result but also at the inevitable cost of incentives. Resources used for one purpose are not available for another and hence have an opportunity cost. At present, comprehensive information for a continual evaluation of the costs and benefits of export incentives is not available in most developing countries. In particular, statistical information necessary to assess financial implications is highly incomplete. It thus seems important that comprehensive and up-to-date records and statistics should be maintained with regard to each export incentive measure to permit an assessment of their costs and benefits and provide the basis for improvements in policy design. 63/

4. Compatibility with GATT provisions

131. Export incentives are in confomity with GATT rules as long as their use is consistent with the competitive and development needs of the developing country which grants the incentives. 64/ Thus, export incentives are meant to offset competitive disadvantages inherent in the developmental stage of the economies of developing countries. They are provided so as to put these countries on an equal footing with other competitors, rather than to obtain an "unfair" disadvantage in world markets. Most developed countries also have recourse to some major export incentive measures. 65/

132. The need for export incentives will diminish with progressing development. Thus, export financing schemes will become less important for exporters as and when the domestic banking sectors, capital markets and manufacturing industries in a developing country gain in competitive strength. A number of developing countries which operated facilities for the provision of short-term export finance at earlier stages in their development process phased them out once sufficient competitiveness had been built up. Income tax and import duty concessions have been, in any case, permitted under GATT provisions irrespective of the issue of differential treatment for developing countries, as long as the concessions do not provide for rebates in excess of the amount of the tax or import duty concerned. 66/ Likewise, export credit insurance facilities which operate on a cost-recovery basis are not in contravention of GATT rules on export subsidies. 67/

C. Sectoral development programmes

133. Trade and industrial policies should concentrate on the development of fewer industries on the basis of doing a few things well rather than a lot of things badly. Sectoral development programmes can serve to enhance the competitiveness of selected industries by correcting market failures which affect the promoted production branches and by active support which aims to accelerate the pace of the sector-specific capability-acquisition process.

1. Choice of industries for promotion

134. The selection of industries for promotion constitutes a neuralgic point in the decision-making process where government failures can occur. The choice of industries is easier for a developing country which is in the phase of "catching-up" industrialization, than for a developed country which is

trying "to push the frontier". As the evolution of existing industries and their requirements in terms of skills, scales and technologies are known from the experience of other countries, a developing country can more easily identify the next set of activities which it can undertake and promote efficiently. For developed countries, with no clear model to follow, it is much more difficult to get involved in helping to identify industries and technologies of the future. Sectoral development programmes of developing countries would need to target activities that have a good chance of reaching international competitiveness in a reasonable period. To develop linkages between industries, the promotion of a particular industrial sector can be combined with support for one or two of its supplier industries which provide important production inputs.

2. Choice of support measures

135. Interventions will differ by country and by activity, and cannot be decided upon on a priori grounds. Support measures, both in factor and product markets, have to be based on a realistic assessment of the technological, input, scale and institutional constraints facing the development of promoted sectors and of the time needed to mount necessary efforts. Thus, market failures in the form of barriers to entry can be significant, such as large fixed cost of entry, inadequate access to technology, or, on the demand side, imperfect information of consumers about product attributes (which benefits established brand names vis-à-vis newcomers).

136. Temporary protection from import competition can be an important policy tool to correct for market failures which result in particular from the existence of a steep learning curve. Infant industries can be at a considerable disadvantage as they may be trapped at positions higher up their learning curve. Moreover, in the presence of economies of scale, temporary protection gives firms time to lower cost as output increases. The level and period of protection will depend on the complexity, scale and skill intensity of the activity. 68/ Protection judiciously adjusted to the learning periods of particular production sectors may even make it easier for firms to penetrate export markets by creating profits with which to meet fixed costs and permitting export sales at prices below average cost. 69/ It may also be noted that the leading industrial sectors remained largely the same (though different in each country) as the switch from import substitution to export promotion policies occurred in major developing countries (e.g. Republic of Korea, Taiwan Province of China, Turkey). This lends further support to infant industry arguments for protection. It shows that the "breathing space" provided by protection can be used effectively to build skills, technological capability and inter-industry linkages.

137. Preferential investment finance and low-cost working capital as well as assistance with the absorption of new technologies, with selecting foreign capital equipment and technology and with training in specific skills (which may, in turn, be geared to new technologies) are further support measures which have been used in the context of sectoral development programmes to remedy constraints in promoted industries. Public or semi-public training and technology institutes can play crucial roles in helping enterprises to master new skill and technology requirements, and export promotion agencies can provide support for marketing efforts.

3. Failures and safeguards

138. There are three main reasons why sectoral development programmes have in many cases failed to build internationally competitive supply capabilities.

Wasteful big-push strategies

139. Failures have occurred where developing countries attempted to "make a leap" into an industry which was far beyond their existing capabilities in terms of financial, human and technological resources. Such big-push strategies have often been ill-timed. Unrealistic choices have simply drawn scarce resources away from more advantageous economic uses. Governments which have implemented successful sectoral strategies have guided capability-building efforts into areas of their countries' emerging comparative advantages.

Risk of preserving unviable capacity

140. Government-supported sectoral development programmes carry the risk that enterprises might reduce their own investments in capability acquisition and slacken their efforts to improve competitive strength. Home market protection, in particular, can induce firms to content themselves with domestic operations and neglect export expansion. The experience of some developing countries suggests a number of safeguards which have been successfully employed to ensure that government support was geared systematically to the achievement of international competitiveness.

141. Thus, the assurance of competition among domestic firms in the home market can provide an important spur to enterprises to improve efficiency in production. Furthermore, enterprises should be encouraged to enter export markets as soon as the learning process permits. To this end, it is important that the potential anti-export bias of infant industry protection be completely offset by the application of export incentives. 70/ Export efforts can also be encouraged by making the availability of attractive financial incentives (e.g. preferential investment finance and low-cost working capital) granted in the context of sectoral development programmes dependent on the fulfilment of export targets set by the Government. Moreover, Governments should monitor closely both export performances (as an indicator of competitive strength) and the domestic resource cost of incentives (as the "price" paid for efficiency improvements). Support measures may need to be revised in the light of experience to improve their impact on the process of capability acquisition and export growth. Pre-announced timetables for government-supported sectoral development programmes can help ensure that government assistance does not degenerate into a permanent economic rent keeping non-viable production in operation.

Insufficient institutional capability of Governments

142. The effective conduct of sectoral targeting depends critically on the professional expertise, administrative capabilities and autonomy of the Government. The more selective interventions become, the greater will be the requirements regarding economic and technological information, institutional capacity, and consultations with the private sector. 71/ Failures have occurred where Governments lacked the institutional capability to correctly

identify the constraints on the promoted industries, to tailor support measures to sector-specific needs or to implement sectoral programmes which required detailed economic and technological information and highly specific interventions in factor and product markets.

143. The design and implementation of sectoral targeting needs to be based on a realistic assessment of the Government's ability to intervene at various levels and in various activities. At earlier stages of development, sectoral development programmes should be relatively simple in design, aimed at easing basic financial, skill and technological constraints on the promoted activities. With progressing development and growing sophistication of the industrial base, sectoral development plans will become more complex undertakings. Technical cooperation with international organizations can play an important role in assisting developing countries with the choice of sectors for promotion and the design, implementation and monitoring of programmes to build competitive supply capabilities into selected industries.

D. The use of export processing free zones (EPZs)

1. Objectives

144. Developing countries should clearly define in their industrialization and export policies the function they wish an EPZ to perform, taking account of the developmental impact of EPZs in the past. The EPZ device may be considered primarily as an additional source of foreign exchange earnings and employment. Other contributions which EPZs might make could be regarded as desirable externalities. EPZs should not necessarily be expected to contribute significantly to enhancing labour skills and technological capabilities of the host economies, or to develop linkages with domestic sectors. Efforts to improve the industrial and technological base of the host countries can concentrate on industries in the domestic economy. Foreign exchange earnings accruing from EPZ operations may be used to aid industrial development outside the zones.

145. Developing countries must take care not to give EPZs undue weight in the manufacturing sectors of their economies. EPZs should be seen as an adjunct to other forms of industrial and export development. In particular, small countries have to avoid the danger that industrial and export growth become dependent on what are essentially mere assembly operations. Undue reliance on such operations may have the adverse effect of freezing the country's comparative advantage and may jeopardize efforts to improve simultaneously the host economy's own industrial and technological base. 72/

146. For developing countries or specific regions of these countries EPZs may be an initial step towards export-oriented industrialization. Labour-intensive processes and component specialization in EPZs within vertically integrated transnational industries constitute a relatively easy avenue through which developing countries with infant industrial export sectors could expand manufactured exports and realize immediate foreign exchange earnings required for development.

2. Constraints on upgrading production

147. The transformation of activities in EPZs from essentially assembly and other low-skill operations into more complex and sophisticated manufacturing operations with greater linkages to the domestic economies is subject to a number of constraints. First, the investment strategies of foreign corporations have essentially been based upon the utilization of low-cost labour. When wage levels rise in the host developing country, the response is more likely to be relocation to another low-cost developing country rather than the upgrading of their current production processes. Secondly, EPZs do not create, but can only build upon, the comparative advantage of the host economy. For many developing countries, especially for those at an early stage in the industrialization process, such a comparative advantage will not extend to the production of good-quality intermediate goods which could serve as inputs for production in EPZs. Thirdly, the trade policies of developed countries with respect to imports of many of the goods typically produced in EPZs are designed to encourage the use of their own intermediate goods in the products subsequently imported. 73/ Finally, as and when internationally competitive production inputs become available locally, the administrative ease of the import duty exemption associated with EPZ operations becomes less important while other considerations, such as proximity to local supplies, can become more determinant in the locational decision of investors.

3. Investment by domestic firms

148. EPZs should not be considered as exclusive instruments for attracting foreign investment. Local participation, in particular in the form of joint ventures, should be encouraged. Stronger investment by domestic firms in EPZ industries will reduce the instability and footloose character of EPZ manufacturing and raise domestic value added in EPZ exports. Possible candidates for independent local ventures in EPZs could, for instance, be component manufacturers exporting the same item to a number of firms (in EPZs and elsewhere) in cases where components are standardized for an industry as a whole and production, therefore, benefits from scale economies. 74/

4. Benefits and costs

149. Most importantly, the discounted stream of benefits and costs generated by the EPZ should yield a net present value in order to make the project profitable for the host country. 75/ The main benefit is the export proceeds retained by the host economy as remuneration for domestic resources allocated to the EPZ. Domestic resource costs are incurred, in particular, in establishing and maintaining the EPZ estate, in making available local labour and production inputs for EPZ manufacturing and in granting government subsidies and incentives. The cost of the construction of the EPZ estate and government subsidies and incentives crucially influence the profitability of the EPZs for the host economies. It is important, therefore, to avoid excessive expenditure on EPZ estate development and costly promotion policies. Staged construction of the EPZ estate should be a key element of a prudent EPZ development programme. Preferential charges for the lease of land, factory rental and public services such as electricity and water supply need not be offered. The operational efficiency of EPZs and administrative ease of import

duty exemption, with normally zero opportunity cost for the host economy, should be the major incentive by which any EPZ attracts investors. 76/

E. Approach towards import liberalization

1. Sequence of macroeconomic stabilization and import liberalization

150. Empirical work on the sequencing of macroeconomic stabilization and the liberalization of imports has indicated that macroeconomic stabilization should be the first step. 77/ Several arguments may be advanced in support of this sequence: (a) higher rates of investment will facilitate structural adjustment to the impact of liberalization, but investment is likely to be discouraged by the contractionary policies which are characteristic of stabilization periods; (b) macroeconomic instability may result in unstable relative prices, which will give misleading signals for the reallocation of productive resources; (c) a real exchange rate which is overvalued is likely to remain so if a fiscal deficit is not reduced and will affect exports and discourage new investment in the export sector at a time when import substituting activities are under adjustment pressure due to import liberalization; and (d) balance-of-payments deficits should be brought under control prior to import liberalization because the latter is likely to generate an additional strain on foreign exchange availability.

151. In short, macroeconomic instability does not provide an environment conducive to investment and economic growth. The productive base is, in consequence, unlikely to respond to import liberalization by new investments intended to strengthen supply capabilities in import substituting and export sectors. A major disadvantage of shock treatment is that it enhances both contractionary trends and adverse balance-of-payments effects. It therefore increases both political resistance to reforms and the likelihood that policies will be reversed as a result of mounting foreign exchange constraints. Brazil is a notable example of how macroeconomic instability - associated primarily with unsettled fiscal conditions in this particular case - can hamper a successful structural transformation: since the mid-1980s, the country has experienced a sharp slowdown in the rapid rate of export growth which it had enjoyed after the late 1960s.

2. Implementation of import liberalization

152. Considerable disagreement remains with regard to the scope and pace of import liberalization and the point in time when the liberalization process should commence. "Neo-classical" analysts argue in favour of a simultaneous and essentially uniform reduction of protection in all industrial sectors. 78/ Reductions in protection would not discriminate among different production activities. 79/ Furthermore, protection would be removed for all sectors over the same period of time, which should, in addition, be relatively short. 80/ Periods of three to five years are often cited as adequate. Infant industry protection is admitted but considered to be exceptional, and effective rates of such protection are expected to be uniform, and relatively low. 81/

153. The validity of the concept of rapid wholesale liberalization of all production sectors, with a uniform reduction in protection and a standard period for effecting these reductions, is highly debatable, as experience

demonstrates. The result of relatively rapid wholesale liberalization has, in practice, been very unsatisfactory. 82/ Most of the developing countries which undertook to liberalize imports have proceeded selectively and gradually. A uniform approach cannot do justice to the enormous structural and capability differences that exist between developing countries and between production sectors and their support systems. Industrial activities differ in their skill, scale, technological, organizational and linkage characteristics and so may have different learning periods and costs. Moreover, the various industrial sectors are at different stages of development aimed at achieving international competitiveness. Hence, the magnitude and nature of constraints on the development of full competitive strength will vary significantly among sectors, as will the resources and time required to make supply capabilities competitive in world markets.

154. The uniform approach towards liberalization runs the risk that the indiscriminate and rapid exposure of the whole productive base to import competition will push a greater number of infant industrial sectors which are potentially viable out of the market. Thus, rapid across-the-board liberalization may lead to an irreversible loss of capital and the disappearance of accumulated skills, and it may hold back the development of new, more complex activities.

155. Moreover, it still has to be demonstrated that rapid and broad-based import liberalization is preferable because smaller, more gradual changes may be easily rolled back and could point to a lack of government commitment. Rather, there is indication that targets and policy changes which are modest, but firm and realistic, are likely to be more credible and sustainable than large changes which are, to a degree, "leaps into the unknown", strain governmental institutional capacity and strengthen the impression, dangerous in local politics, that the policy programme is externally imposed rather than internally generated. In addition, sharp distributional changes in the wake of rapid liberalization can create political pressures to reverse course down the line.

156. In determining the level of protection for infant manufacturing activities and the time period over which such protection is withdrawn, policy-makers need to take into account to a greater extent the different learning periods of production sectors and differences in their competitive strength. Hence, the design and implementation of liberalization would need to be more sector-specific. With sector-specific liberalization, the removal of protection from particular sectors would proceed parallel to gradual improvements in their competitiveness. The lowering of protection would be an additional stimulus to improving efficiency, while the pace at which protection was reduced would be tuned so as to allow sufficient time for adjustment efforts of entrepreneurs and government support measures to develop international competitiveness.

157. Sector-specific liberalization would have to be closely coordinated with support measures under sectoral development programmes aimed at building efficient supply capabilities. While consultation with the private sector will be crucial in this regard, policy-makers should withstand demands to delay liberalization beyond the time horizon considered adequate for the achievement of competitiveness by particular production sectors.

158. While sector-specific liberalization (like sectoral development programmes) leads to variations in the level of protection between different industrial activities, the structure of incentives should not create a bias within industries in favour of production for the domestic market. Rather, equal incentives should be provided for selling at home and abroad. It is therefore crucial that export incentives offset the bias in favour of domestic operations implicit in home market protection. Manufactured exports were generally favoured over production for the home market in the policy of the Republic of Korea and the Taiwan Province of China, whereas the anti-export bias was only reduced in many other developing countries, among them Argentina, Brazil, Colombia and Mexico. 83/ A bias against exports has tended to persist despite export incentives where these measures were subject to a complex administrative control apparatus and considerable uncertainty as to their availability. Moreover, the remaining bias was to some extent the consequence of precluding the use of imported inputs in export production when domestic substitutes were available.

159. Gradual import liberalization, in step with improvements in the competitive strength of supply capabilities, is an effective means to keep entrepreneurs on track with their efforts to achieve international competitiveness. A number of developing countries only initiated the process of liberalization well after manufactured exports had begun to grow. 84/ Such strategy runs the risk of slowing down the process of building competitiveness and, more specifically, of learning to analyse the conditions for success in world markets. However, it needs to be kept in mind that import liberalization is far from being a sufficient prerequisite for sustained export growth. Weak supply capacity, poor infrastructure and organizational capabilities limit what can be achieved with the simple manipulation of price incentives through import liberalization (or the exchange rate). Several low-income developing countries such as Cape Verde, Guinea and Senegal are illustrative examples in this regard. 85/

F. Transparent mechanisms: evaluation of benefits and costs of government support

160. The developing countries should assess on a continuous basis the benefits and costs of export incentives, of support measures in the context of sectoral development programmes and of the operation of EPZs. The most appropriate institution to evaluate the costs and benefits of support measures would be a national authority external to, and sufficiently independent from, the political executive and the demands of pressure groups in the private sector. Such independence will allow critical and objective evaluations to be made and thus enable the developing country to keep track of the impact of support measures on export performance and facilitate the feedback of the empirical findings into future policy design.

161. It may be recalled in this context that the Cartagena Commitment adopted at UNCTAD VIII has recommended that Governments consider the establishment of transparent mechanisms at the national level so as to enhance domestic transparency of trade-related policy-making. 86/ Such national mechanisms would be suitable institutions to undertake critical and objective assessments of the costs and benefits of measures to enhance the competitiveness of the productive base.

Notes

1/ See UNCTAD, "Services in the world economy", United Nations Publications, UNCTAD/TDR/8/Offprint, 1989.

2/ For strategic trade policies, see also P. Krugman (ed.), Strategic Trade Policy and the New International Economics (Cambridge, MA: MIT Press, 1986); E. Helpman and P. Krugman, Trade Policy and Market Structure, (MIT Press, 1989); P.S. Nivola, "More like them? The political feasibility of strategic trade policy", The Brookings Review, vol. 9, No. 2 (Spring 1991); N. Schmitt, "New international trade theories and Europe 1992: some results relevant for EFTA countries", Journal of Common Market Studies, (September 1990); J. Brander and B. Spencer, "Export subsidies and international market share rivalry", Journal of International Economics, (1985); R. Baldwin, "High-technology exports and strategic trade policy in developing countries: the case of Brazilian aircraft", in G.K. Helleiner (ed.), Trade Policy, Industrialization and Development (Oxford: Clarendon Press, 1992).

3/ Selective intervention can also aim at specific improvements in factor markets when such improvements are necessary for the development of a specific production sector. Thus, vocational training can be selective in providing specialized engineering expertise to particular industries.

4/ e.g. Republic of Korea, Brazil, Malaysia, Costa Rica, Colombia, China, Turkey. See also UNCTAD, Trade and Development Report, 1992, United Nations publication, Sales No. E.92.II.D.7.

5/ For a detailed analysis of sectoral development programmes of the Republic of Korea, see chapter 7 below.

6/ See Park Yungchui "South Korea's experience with industrial adjustment in the 1970's", Asian Employment Programme Working Paper, ARTEP, Bangkok, 1983. In Taiwan Province of China, the development of basic heavy industries and technology-intensive industries was pursued from as early as the late 1960s. See R. Wade, "State intervention in 'outward-looking' development: neo-classical theory and Taiwanese practice" in G. White and R. Wade (eds.), Developmental States in East Asia, Brighton: Institute of Development Studies, 1985.

7/ See W. Fritsch and G. Franco, Trade Policy Issues in Brazil in the 1990s, UNCTAD, Trade Policy Series, No. 4 (forthcoming).

8/ Mohammed Ariff, The Malaysian External Sector: Policy and Performance, UNCTAD, Trade Policy Series, No. 2 (forthcoming).

9/ See also La Politica Comercial de Costa Rica y Perspectivas para la Decada del Noventa, UNCTAD, Trade Policy Series No. 5, 1992 (mimeo).

10/ See Hong Wang, "Export promotion: Policy and performance in China", UNCTAD (mimeo), Geneva, 1992.

11/ See Ercan Uygur. Policy, Trade and Growth in Turkey, 1970-1990, UNCTAD, Trade Policy Series No. 6 (forthcoming).

12/ International competitiveness is determined not just by nominal exchange rates, but also by differential rates of inflation. The real exchange rate is the nominal rate adjusted by the ratio of a price index for the country concerned to that for its trading partners.

13/ See O.E.G. Johnson, "Currency depreciation and export expansion", Finance and Development, vol. 24, No. 1, (March 1987).

14/ See S.M. Shafaeddin, "The effectiveness of nominal devaluation: the influence of the level of development" in R. Adhikari, C. Kirkpatrick and J. Weiss (ed.), Industrial and Trade Policy Reform in Developing Countries (Manchester University Press, 1992).

15/ See also R. Kitchen and J. Weiss, "Prices and government interventions in developing countries", Industry and Development, No. 20 (1987), UNIDO Publication Sales No. E.86.II.B.7.

16/ The brief period of real depreciation is illustrated for several countries in Anne. O. Krueger, Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences (New York: National Bureau of Economic Research, 1978).

17/ See S.M. Shafaeddin, "The effectiveness of nominal devaluation: the influence of the level of development", op. cit.

18/ Furthermore, the rise in the cost of living and the redistribution of income that a devaluation entails have frequently been criticized for shifting the burden of adjustment to the lower-income groups who are least able to afford it. It is often claimed that devaluation and additional expenditure-dampening measures tax the poor in three ways: by reducing the real wage, increasing unemployment and reducing government services and entitlements. In addition, devaluation will cause other government expenditures to rise, as the cost of their import content and that of debt-servicing go up. See K. Nashashibi, "Devaluation in developing countries: the difficult choices", Finance and Development, vol. 20, No. 1 (March 1983).

19/ See also E.F. Buffie, "Devaluation, investment and growth in LDC's", Journal of Development Economics, vol. 20, No. 2 (March 1986).

20/ See also R. Ffrench-Davis, P. Leiva and R. Madrid, Trade Liberalization in Chile: Experiences and Prospects, UNCTAD, Trade Policy Series, No.1 (1992), United Nations Publication Sales No. E/F.91.II.D.11.

21/ See R. Faini and J. de Melo, "Adjustment, investment and the real exchange rate in developing countries", Economic Policy, October 1990.

22/ For a detailed analysis, see Ghana: Adjustment and Growth, 1983-91, IMF Occasional Paper No. 86, Washington, DC, 1992.

23/ The amount of foreign exchange offered for auction every week was regulated by the central bank. Moreover, not all foreign exchange transactions were conducted through the auction system. Certain key industries and institutions, (e.g. the copper mining sector, Zambian Airlines, some government departments, etc.) continued to rely on an administrative allocation of foreign exchange.

24/ Countries which are members of the West African Monetary Union, such as Senegal and Togo, are bound by a common currency, the CFA franc which is linked by a fixed exchange rate to the French franc. Therefore, the option of influencing trade performance through an active exchange rate policy is not available to these countries.

25/ The Government revalued the domestic currency after agreements with the IMF were terminated.

26/ In particular short-run formal market supply elasticities were much higher for this crop than suggested by production responses because of the prevalence of a large black market. See J. Loxley, "Structural adjustment in Africa: reflections on Ghana and Zambia", Review of African Political Economy, No. 47 (Spring 1990).

27/ See also, P. Nunnenkamp and R. Schneickert, "Adjustment policies and economic growth in developing countries - is devaluation contractionary?", Weltwirtschaftliches Archiv, 1990, no. 3.

28/ On the assumption that pre-tax profits are 25 per cent of value added and the tax on profits is 50 per cent, the forgoing of tax on profits is equivalent to an effective rate of export subsidy of 12.5 per cent. If pre-tax profits are 10 per cent of value added, the forgoing of tax on profits is equivalent to an effective subsidy rate of 5 per cent.

29/ See the findings based on interviews in B.I. Cohen, Multinational firms and Asian exports (New Haven and London: Yale University Press, 1975), p. 137; Helen Hughes and You Poh Seng (eds.), Foreign Investment and Industrialization in Singapore (Canberra: Australian National University Press, 1969), p. 183; Yair Aharoni, The Foreign Investment Decision Process (Boston: Harvard University Graduate School of Business Administration, 1966), pp. 234-35.

30/ Foreign investors frequently provide imported machinery and equipment instead of equity contributions. Such machinery can be priced more expensively than comparable equipment available from world market sources of supply, that is, the price would exceed the true economic value of the machinery. The foreign enterprise will, nevertheless, take the higher book value as the basis for depreciation purposes and calculation of profits before tax.

31/ See the illustrative examples in R. Hellawell, "United States income taxation and less developed countries: a critical appraisal", Columbia Law Review 66 (December 1966), esp. pp. 1394-97; B.I. Cohen, op. cit., pp. 137-138.

32/ Import duty drawback or permission to import free of duty is also granted sometimes in respect of imports of machinery and equipment required for export production.

33/ For a more detailed discussion, see "Incentives for industrial exports", study by the UNCTAD secretariat, United Nations Publication, Sales No. E.82.II.D.4.

34/ For a detailed discussion see "Institutional arrangements in developing countries for industrial and export finance with a view to expanding and diversifying their exports of manufactures and semi-manufactures", report by the UNCTAD secretariat, United Nations Publication, Sales No. E.80.II.D.6.

35/ e.g. United States of America and Japan.

36/ The Korea Export-Import Bank and the Industrial Development Bank of India.

37/ In Venezuela, the public Industrial Bank could furnish preferential pre- and post-shipment finance without recourse to the exporter. The Bank's parent institution, the government-owned Corporación Venezolana de Fomento would guarantee the loan granted by the Industrial Bank.

38/ The scheme in Ghana has been confined to the provision of pre-shipment guarantees issued directly to the commercial bank that finances the exporter.

39/ For example, risk of non-payment by the buyer owing to circumstances beyond his control.

40/ For a detailed discussion of export credit insurance facilities, see "Export credit insurance as a means of expanding and diversifying exports of manufactures from the developing countries", report by the UNCTAD secretariat, United Nations Publication, Sales No. E.76.II.D.6.

41/ For a detailed evaluation, see "The administration of incentives for industrial exports in developing countries", report by the UNCTAD secretariat, UNCTAD/ST/MD/17 (1978).

42/ Indicative evidence of the degree of optimality or sub-optimality of resource allocation to an industry is provided by the domestic resource cost of a marginal unit of foreign exchange earned from exporting or saved through import substitution by this industry. Efficient resource allocation requires that the domestic resource cost value - i.e. in its simplest form the ratio of the domestic resource cost to the foreign exchanged earned or saved, both evaluated at their opportunity cost - be lower than the shadow rate of exchange. The greater the differential, the better off the country will be.

43/ See J.B. Donges, "A comparative survey of industrialization in fifteen semi-industrialized countries", Weltwirtschaftliches Archiv, vol. 112 (1976); W.G. Tyler, Manufactured export expansion and industrialization in Brazil, Kieler Studien No. 134, Tübingen, 1976; R. Banerji, Exports of manufactures from India, Kieler Studien No. 130, Tübingen, 1975; Deepak Lal, "Indian export incentives", Journal of Development Economics, vol. 6 (1979); V.N. Balasubramanyam, The economy of India, London, 1984, p. 124; R. Banerji and J.B. Donges, "The domestic resource cost concept - theory and an empirical application to the case of Spain", Kiel Working Paper No. 24 (1974), Kiel Institute of World Economics; the results of J.R. Mendoza de Barros et al., reported in Tyler, op. cit., table VII - 8; M. Girgis, Industrialization and trade patterns in Egypt, Kieler Studien No. 143, Tübingen, 1977; A.O. Krueger, Foreign Trade regimes and economic development: Turkey, a special conference series on foreign trade regimes and economic development, vol. I, National Bureau of Economic Research, New York, 1974.

44/ See, for India, J.N. Bhagwati and P. Desai, "India - Planning for industrialization", Oxford University Press, 1970, chapter 20. A net loss is incurred for the economy whenever incentive outlays go beyond neutralizing the effect of currency overvaluation, e.g. are in excess of the difference between the official and the shadow rate of exchange. See also, R. Banerji, "Exports of manufactures from India", op. cit., p. 223.

45/ J.N. Bhagwati stresses the budgetary constraints on subsidies as one reason for the apparently superior resource allocation under a policy that promotes exports. See J.N. Bhagwati, "Foreign trade regimes and economic development: anatomy and consequences of exchange control regimes", a special conference series on foreign trade regimes and economic development, vol. X, National Bureau of Economic Research, New York, 1978, p. 211.

46/ See for instance, Strategic Industries in a Global Economy: Policy Issues for the 1990s, OECD International Futures Programmes (OECD, Paris, 1991).

47/ See also, C.I. Bradford, Jr., "Trade and structural change: NICs and next tier NICs as transitional economies", World Development, vol. 15, No. 3 (1987); M. Fransman, "International competitiveness, technical change and the State: the machine tool industry in Taiwan and Japan", World Development, vol. 14, No. 12 (1986).

48/ See also, R. Luedde-Neurath, Import controls and export oriented development: a reassessment of the south Korean case (Westview Press, Boulder, CO, United States of America, 1986). In the same vein, Taiwan Province of China maintained extensive import restrictions. Thus, import licensing has been used to prevent the import of machine tools where products that are "equivalent" in terms of price and quality were locally available. See R. Wade, "Dirigisme Taiwan-style", IDS Bulletin (April 1984).

49/ See, in particular, C.I. Bradford, Jr., "Trade and structural change: NICs and next tier NICs as transitional economies", World Development, vol. 15, No. 3, (1987).

50/ See also, M. Fransman, "International competitiveness, technical change and the State: the machine tool industry in Taiwan and Japan", World Development, vol. 14, No. 12 (1986).

51/ For further details see H. Pack and L.E. Westphal, "Industrial strategy and technological change: theory versus reality", Journal of Development Economics, vol. 22, No. 1 (1986).

52/ See also, L.P. Jones, Public enterprise and economic development: The Korean case (Korea Development Institute, Seoul, 1975).

53/ The analysis draws, to some extent, on the findings of H. Pack and L.E. Westphal, "Industrial strategy and technological change: theory versus reality", Journal of Development Economics, vol. 22, No. 1 (1986).

54/ On this particular point see also S. Jacobsson, "Technical change and industrial policy: the case of the computer numerically controlled lathes in Argentina, Korea and Taiwan", World Development, vol. 13, No. 3 (1985).

55/ See also, L.E. Westphal and K.S. Kim, "Korea", in: Bela Balassa et al., Development strategies in semi-industrial countries (John Hopkins University Press, for the World Bank, Baltimore, MD, 1982); C.H. Nam, Trade and industrial policies, and the structure of protection in developing countries in the Pacific basin (Korean Development Institute Press, Seoul, 1981); A.H. Amsden, Asia's Next Giant - South Korea and Late Industrialization, (New York, Oxford: Oxford University Press, 1989).

56/ The payment of customs duty is only required as and when products from the EPZ enter the domestic market of the country hosting the EPZ.

57/ See for a detailed discussion "Export processing free zones in developing countries: Implications for trade and industrialization policies", study by the UNCTAD secretariat, United Nations Publication Sales No. E.85.II.D.17.

58/ For a more detailed discussion, see UNCTAD, Trade and Development Report, 1992, United Nations Publication Sales No. E.92.II.D.7.

59/ See also UNCTAD, Trade and Development Report, 1992, United Nations Publication Sales No. E.92.II.D.7.

60/ See for a detailed analysis R. Ffrench-Davis, P. Leiva and R. Madrid, Trade liberalization in Chile: Experiences and Prospects, UNCTAD, Trade Policy Series No. 1 (1992), United Nations Publication Sales No. E/F 91.II.D.11.

61/ For a detailed discussion, see A. ten Kate, "The Mexican trade liberalization of 1985-1987: lessons from experience", UNCTAD (mimeo), 1991.

62/ e.g. the case of cocoa: Brazil, Ghana, Côte d'Ivoire and Nigeria account for 70 per cent of world exports. Three of them devalued and one (Côte d'Ivoire) raised producer prices in the 1980s. Cocoa output rose by a third between 1983 and 1987, until prices collapsed in 1988. See also for the fallacy of composition argument, M. Goldstein, "The global effects of fund-supported adjustment programmes", International Monetary Fund, Occasional Paper No. 42 (March 1986), Washington, D.C.

63/ See also section F below, "Transparent mechanism: evaluation of benefits and costs of government support".

64/ See, in particular, Article 14 of the "Agreement on interpretation and application of articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade" (the GATT Code on export subsidies).

65/ e.g. fiscal incentives; favourable longer-term export finance; export credit insurance; provision of foreign market information.

66/ See annex I, ad article XVI in GATT Basic Instruments and Selected Documents, vol. 4 (Sales No. GATT/1969-1): "The exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy".

67/ In fact, a number of the export credit insurance schemes in developed market-economy countries have, at times, had difficulty to operate on a cost-recovery basis.

68/ Infant industry protection is theoretically justifiable when firms cannot finance the learning process (capital market failures), cannot appropriate all its benefits (externalities) or under-invest in learning because they are risk-averse or unable to predict the outcome (information failure or "learning to learn" phenomena). See S. Lall and G. Kell, "Industrial development in developing countries and the role of government interventions", Banca Nazionale del Lavoro Quarterly Review, No. 178 (September 1991).

69/ The strategy which was pursued by the Republic of Korea provides a good example in this regard. See also P. Krugman, "Import protection as export promotion", in H. Kirzkowski (ed.), Monopolistic Competition and International Trade (Oxford: Oxford University Press, 1984).

70/ Regarding the neutrality of the incentive structure see also below section E. "Approach towards import liberalization".

71/ See also L. Reynolds, "The spread of economic growth to the Third World, 1850-1950", Journal of Economic Literature, vol. 21 (1983). Having surveyed the experience of development in forty-two (42) contemporary developing countries, Reynolds concludes that "the single most important explanatory variable (in economic development) is political organization and the administrative competence of government".

72/ For this particular point see also S. Lall, "Offshore assembly in developing countries", National Westminster Bank Quarterly Review, August 1980.

73/ Many developed countries exempt from customs duty that portion of the products imported which consists of goods supplied from domestic sources.

74/ See G.K. Helleiner, "Manufactured exports from less developed countries and multinational firms", Economic Journal, vol. 83 (1973), pp. 42-43.

75/ For the main cost and benefit items see "Export processing zones in developing countries: Implications for trade and industrialization policies", study by the UNCTAD secretariat, op. cit., table 4.

76/ The duty-free import concession is the modus vivendi of the zone. Investment in EPZs would not take place in the absence of import duty exemptions.

77/ See, for example Anne O. Krueger, Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences, (New York: National Bureau of Economic Research, 1978); Sebastian Edwards, "The order of liberalization of the external sector in developing countries", Princeton Essays in International Finance, No. 156, December 1984; Michael Michaely, Demetrios Papargergiou, and Armeane M. Choksi, Liberalizing Foreign Trade: Lessons of Experience from Developing Countries, (Oxford: Basil Blackwell, 1991); and Vinod Thomas and John Nash et. al., Best Practices in Trade Policy Reform (Oxford: Oxford University Press, 1991).

78/ There is relatively broad agreement among economic analysts about the first phase of reforms, e.g. the implementation of a purely nominal shift in the form of protection: quantitative restrictions would be removed and replaced by equivalent tariff protection. The reason for this is that the quantitative restrictions eliminate the price mechanism and provide the recipient of the quota or licence with an economic rent such as monopoly profits. Tariffs are preferable, it is argued, because they are more transparent and the revenue accrues to the Government.

79/ None the less, various choices among alternative uniform approaches are admitted: (i) equiproportional tariff reductions, for instance, reductions amounting to 10 per cent; (ii) reductions by equally large absolute doses, for instance by 10 percentage points; (iii) the "concertina method" reducing above-ceiling protection rates to a ceiling that is lowered over time; and (iv) tariff reductions on all products at differing rates, with higher tariffs being reduced more than lower ones. The last alternative, used in the Tokyo Round of multilateral negotiations, was considered to have the advantage of avoiding the possibility that only the "water" in the tariff would be eliminated at the initial stages.

80/ Periods of five to seven years have been suggested. See the World Bank, World Development Report 1987.

81/ See, for instance, B. Balassa, "Reforming the system of incentives in developing countries", World Development, vol. 3, No. 6 (June 1975).

82/ See chapter 9 above, section B. "Experience with rapid wholesale import liberalization".

83/ See B. Balassa et al., Development Strategies in Semi-industrial Economies, published for the World Bank by the Johns Hopkins University Press, Baltimore and London, 1982.

84/ See above chapter 2.

85/ See La Apertura Comercial en Cabo Verde, UNCTAD, Trade Policy Series No. 3 (mimeo); La Politique Commerciale du Senegal (1970-1990). UNCTAD, Trade Policy Series No. 7 (mimeo).

86/ See para. 132 of the Cartagena Commitment (TD/364).